NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/131

3:00 p.m., August 31, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
A. Donoso	M. A. Weitz, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
	T. Alhaimus
H. Fujino	T. Yamashita
G. Grosche	
	Jaafar A.
	L. Leonard
A. Kafka	
G. Lovato	N. Coumbis
	G. Gomel, Temporary
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
	A. K. Juusela, Temporary
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

African Department: O. B. Makalou, Deputy Director; M. Sidibé. Asian Department: K. A. Al-Eyd, I.-S. Kim, K. Saito, S. Takagi. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; P. J. Quirk. External Relations Department: C. S. Gardner, Deputy Director. Legal Department: G. P. Nicoletopoulos, Director; G. F. Rea, Deputy General Counsel; Ph. R. Lachman, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; M. P. Dooley, T. Gudac, D. J. Mathieson. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; D. Berthet, M. N. Bhuiyan, W. J. Byrne, D. S. Cutler, W. E. Hermann, T. B. C. Leddy. Western Hemisphere Department: M. Caiola, J. P. Guzman, A. M. Jul, T. M. Reichmann, S. C. de Sosa. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, E. A. Ajayi, H. A. Arias, S. E. Conrado, S. El-Khouri, K. A. Hansen, W. Moerke, G. E. L. Nguyen, J.-C Obame, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, I. Angeloni, R. L. Bernardo, J. Bulloch, L. E. J. M. Coene, G. Ercel, C. Flamant, V. Govindarajan, D. Hammann, N. U. Haque, L. Ionescu, H. Kobayashi, A. Koné, E. Landis, K. Murakami, E. Olsen, E. Portas, M. Rasyid, J. Reddy, J. E. Rodríguez, A. A. Scholten, Shao Z., S. Sornyanyontr, A. J. Tregilgas, A. Yasseri.

1. GUYANA - 1984 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION RELATING TO COMPLAINT UNDER RULE K-1

The Executive Directors considered the staff report for the 1984 Article IV consultation with Guyana (SM/84/158, 7/5/84), together with a supplement to the staff paper relating to the review of the Executive Board's decision to limit Guyana's use of the Fund's general resources (EBS/84/47, Sup. 4, 8/29/84). They also had before them a report on recent economic developments in Guyana (SM/84/169, 7/20/84).

Mr. Kafka stated that his Guyanese authorities appreciated the care with which the staff had prepared the consultation report. While they would have formulated the analysis of recent developments somewhat differently, they did not disagree with the general thrust of the staff's recommendations. There could be no doubt of the extreme seriousness of Guyana's economic situation. The decline in real per capita GDP since 1980 had amounted to 18 percent, and the extent to which the growth of the parallel economy had compensated for that decline was uncertain. Recent developments were caused by both external and internal factors, but he and his authorities placed much greater emphasis on the former. The terms of trade had deteriorated since 1980 by almost 40 percent; Guyana had an unusually open economy and even in 1983 had exported more than 50 percent of its GDP, so that the terms of trade loss alone would suggest a reduction of 20 percent in real income. His authorities correctly believed that the solution to the problem caused by the terms of trade had to be found in policy reforms as well as in foreign assistance to the extent feasible, as both elements were intimately connected.

The minor recovery in GDP foreseen for 1984 could not be extrapolated with assurance to future years, Mr. Kafka continued. A further decline in GDP was likely to occur in the absence of decisive measures because the economy was not producing the resources necessary to maintain existing plant at its normal operating capacity. There should be no illusions about the implications of the high investment ratio in Guyana, which had averaged 30 percent of GDP between 1980 and 1983. Leaving aside the statistical problems associated with the difference between actual and recorded GDP, a major share of investment was required merely to maintain the sea wall because most of the country was below sea level. Guyana faced, therefore, a problem not only of excess demand but one of supply. Unless industrial plant could be improved, the transport system maintained, fertilizers made available, and the like, national output could not be sustained even at its current reduced level. Clearly, fundamental organizational changes were required to solve the supply problem; nevertheless, production of the bauxite, rice, and sugar industries could not be raised significantly in the absence of urgently needed material inputs from overseas. At present, such inputs could not be financed.

The rehabilitation of Guyana's economy involved pricing and exchange rate policies, in addition to organizational decisions and external assistance, Mr. Kafka observed. The authorities had already devalued the currency once in 1984. The feasibility of further devaluations--which, to be effective, would have to be much larger, without creating neutralizing wage pressures--deserved serious consideration. Many commodities had been freed from price controls in 1983 and to a greater extent in 1984. The authorities had no difficulty with the principle of adjusting prices. In particular, they did not share the staff's concern about the price-setting powers of the Guyana Rice Board because of the changes in the institutional framework described in SM/84/169. Moreover, it appeared that rules could be drafted to bind the Rice Board in the exercise of those powers. Considerable rationalization in the setting of prices for producers and domestic consumers had already occurred. The Government and the Inter-American Development Bank had agreed on price policy and on arrangements for dismantling the Rice Board. In any case, the Government had indicated its continued support of an increase over time in the prices of both sugar and rice. However, it could not be too strongly stressed that the major supply constraint at present was not price but the availability of fertilizers and machinery.

The staff also indicated the need for far-reaching improvement in fiscal policy, Mr. Kafka noted, a point with which his authorities fully agreed. Guyana had undertaken some courageous measures in that respect. The authorities had reduced the number of public sector employees, frozen minimum wages, and placed strict expenditure controls on government services, but additional efforts would be required. Changes were also necessary in monetary policy, particularly with regard to interest rates. The Minister of Finance and the Governor of the Bank of Guyana; had recently held discussions with the Fund staff in Washington and had submitted a program of action; the staff was studying the program and would comment shortly.

Mr. Gomel recalled that when the Executive Board had taken up the complaint under Rule K-1 regarding Guyana's overdue obligations to the Fund (EBM/84/88, 6/6/84), his chair had stated its agreement with the practice of not engaging in discussions on the use of resources with members that were in arrears to the Fund. His chair had also stressed that it was incumbent upon the Fund to assist members in their endeavors to find ways to settle their overdue payments. The Fund's advice on a package of domestic adjustment measures had, therefore, been important for Guyana, and his chair had suggested that the staff should make clear, concrete recommendations on such a package. In that regard, the present Article IV consultation was welcome.

It was not clear whether domestic adjustment policies alone could overcome the problem of arrears and stabilize a seriously dislocated and unbalanced economy, Mr. Gomel continued. Domestic adjustment would have to be supplemented by external concessional assistance, which had become, in the present and other cases, increasingly conditional upon the Fund's support of a stabilization program. In view of the Executive Board's decision prompted by Guyana's payments arrears, no such program could be envisaged at present. Nonetheless, corrective action should be taken by the authorities, which might renew lenders' and donors' confidence in the country's ability to undertake a sounder stabilization effort. The policy package needed to reverse the precarious economic situation was outlined in SM/84/158. Such a package, even in the absence of a full-fledged Fund-supported program, provided a mechanism for unlocking the foreign resources necessary to reduce outstanding arrears and to resume normal trade flows.

Priority should be assigned to generating of domestic savings, through the compression of public spending and, the overhaul of the domestic price structure, as well as to increasing available foreign exchange and thus the country's capacity to import and productive potential, Mr. Gomel commented. Such action required careful management of the exchange rate with a view to channeling foreign exchange receipts back from the parallel to the official market and reversing the upward trend in balance of payments deficits. On the domestic side, the supply policies already put in place in major sectors of the economy--bauxite, rice, and sugar--appeared well designed and should be carried through to the fullest degree. In particular, domestic subsidies should be removed. As for the price-setting mechanism, it would be more feasible to adopt a process of successive price adjustments rather than to move quickly to a generalized freely determined price system. On public finances, it was imperative that spending be sharply curtailed as long as revenue collection failed to improve because of the pervasive unrecorded economy.

Signs of recovery in the trade account were emerging, Mr. Gomel noted. But if Guyana intended to profit from a more promising external environment for its export prospects, it needed to regain competitiveness. With regard to the review of the decision adopted by the Executive Board at EBM/84/88, 6/6/84), it was encouraging that Guyana had made recent payments and that it had announced further monthly payments through the end of 1984. Nonetheless, additional action was needed if the country was to become current on its debt to the Fund.

Mr. Clark remarked that there could be no doubt about the gravity of the economic situation that Guyana faced. GDP had declined by almost 20 percent in the three years to 1983, external debt was more than 150 percent of GDP, and external arrears alone exceeded GDP. The situation reflected the severe structural weaknesses of the economy, particularly a very large public sector deficit and a heavily distorted pattern of relative prices. On the occasion of the previous Article IV consultation (EBM/83/152, 11/4/83), his chair had stated that there was a clear need for decisive, radical action, a view that had been repeated in June 1984 when the question of arrears had been considered. The need had not diminished since that time. He agreed with the staff regarding the focus of the adjustment strategy. One element would have to be a substantial reduction in the fiscal deficit, particularly an improvement in the financial position of the public enterprises and a major tightening in the current expenditures of the Central Government. A second, partly related, element would have to be restoration of an appropriate pattern of prices, with emphasis on the exchange rate and the prices of the public enterprises. Such measures should help to bring the parallel economy back within the formal sector and to increase the contribution of domestic savings to financing the rehabilitation of Guyana's export-oriented industries.

The staff indicated that the Guyanese authorities recognized the need for measures along those lines, Mr. Clark continued. However, it was disappointing that so little of that recognition had been translated into action since the 1983 Article IV consultation, or indeed since the 1982 consultation (EBM/82/142, 11/5/82). The authorities had taken some measures, but they had not been adequate by any means. For example, the Guyana dollar had been devalued by 20 percent in January 1984, but the real effective appreciation since the previous adjustment in 1981 was estimated by the staff to have been at least 70 percent. The staff noted that the Guyanese authorities had indicated that "the present and prospective availability of foreign exchange did not permit them to effect payment of the overdue amounts." At the same time, they had expressed the hope that a way could be found to enable Guyana to have a program supported by the Fund. It would be useful if Mr. Kafka could confirm that the authorities understood the Fund's practice in relation to program negotiations and arrears. Nevertheless, the Fund could offer technical assistance formulating appropriate policies; he would support the continued provision of such assistance if it were considered to be appropriate.

Finally, the collaboration between the staff of the Fund and of the World Bank in relation to Guyana was welcome, Mr. Clark stated, and he hoped that it would continue. The World Bank should play a major role in assisting with the rehabilitation of the economy. However, experience suggested that an appropriate macroeconomic policy framework would be required to ensure success.

Mr. Templeman commented that the staff made clear that the economic crisis in Guyana was continuing. The parallel economy had come to encompass the domestic production and exchange of goods and services, and not only activity in the foreign sector. Arrears to foreign creditors had increased by $200 million in 1983 and by $44 million in the first three months of 1984. Arrears to the Fund remained, for some payments, more than one year overdue. The authorities were reported to be interested in a Fund-supported program, which would help them to implement an adjustment program and enhance their ability to earn the foreign exchange needed to make repayments to the Fund. However, since a program was out of the question at present, the Government would have to act forcefully on its own. The authorities should start with the recommendations made by the staff.

He agreed especially with the staff view that domestic savings would have to be mobilized to provide the resources needed for economic rehabilitation, Mr. Templeman continued, as foreign borrowing was not an option available to Guyana at present. One method of generating resources was to increase producer prices so that costs, including depreciation, were covered. The actions in 1982 and 1983 in the rice sector, which had returned several of the responsibilities of the Guyana Rice Board to the private sector, were indications of the Government's awareness of parastatal inefficiency. He urged that more areas of activity be transferred from the public to the private sector, especially in the sugar industry. Given that the domestic price of sugar was barely more than half the production cost, the Guyana Sugar Corporation remained a large drain on the budget. More generally, tight central government control over all public sector enterprises, especially with regard to prices, contributed to the rigidity in the economy and encouraged the underground economy.

Inappropriate prices were also connected to the extreme overvaluation of the Guyana dollar, Mr. Templeman remarked. Foreign exchange in the black market was said to cost three to four times the official rate. The only way to entice foreign exchange earnings from exports back to official channels, and thereby to make them available for general use, was to devalue or to move to a floating rate system. Such action would be the most useful step that the Guyanese authorities could take at present to begin returning their economy to good health. The feared consequence of inflation would have to be contained by means of restrictive monetary and fiscal policies. Furthermore, the increase in the public sector deficit to almost 69 per cent of GDP in 1984 was argument enough for fiscal restraint.

Although he accepted that some of Guyana's problems had been greatly aggravated by international events beyond its control, Mr. Templeman said, there had obviously been policy inadequacies. In any event, those problems would have to be dealt with, and only a concerted effort to implement corrective macroeconomic policies and to deregulate the economy, including the domestic and foreign sectors, could turn the situation around. Until then, economic growth would be slow, foreign exchange would not be available for repayment to the Fund and for other purposes, and Guyana would continue to be denied access to Fund resources.

Mr. Leonard noted that Guyana was facing a difficult situation; the thrust of the staff proposals to deal with it centered on managing the exchange system to allow the imports necessary to the supply side of the economy. The proposals also involved the generation of public savings and other fiscal action to enable the Bank of Guyana to regain control over the expansion of monetary aggregates and to stem the loss of reserves. Another prominent feature of the proposals was the adoption of reforms to free the operation of the economy and to remove distortions. Although the measures would be difficult to take, they constituted the means for returning to balanced management of the economy and to badly needed economic growth.

It was encouraging that the authorities broadly accepted the staff's assessment of the economic position, Mr. Leonard concluded. He urged them to accept the necessity of acting upon that assessment. In that regard, Mr. Kafka's indication that a program of action had been submitted to the Fund was welcome. He hoped that it would be implemented through a comprehensive stabilization program.

Mr. Weitz agreed that Guyana was facing a difficult economic situation. Since the mid-1970s, economic performance had been weak and most aspects of the economy had deteriorated. Between 1977 and 1983, real GDP had declined by 25-30 percent; the overall deficit of the public sector had increased from 13 percent of GDP in 1978 to 62 percent in 1983, and the balance of payments deficit on current account had risen from 6 percent of GDP in 1978 to 33 percent in 1983. Exogenous factors had contributed significantly to the deterioration of the economy. Weak foreign demand and a decline in international prices had adversely affected the sugar and bauxite industries. Guyana had been affected more than most countries by the increase in petroleum prices because of the bauxite industry's heavy dependence on imported energy sources. Moreover, poor weather had curtailed agricultural output, affecting the major export crops in particular. As Mr. Kafka had noted, for such an open economy that exported such a high percentage of SDP, the deterioration in the terms of trade since 1980 suggested a 20 percent loss of real income.

The impact on traditional sources of foreign exchange of adverse conditions in international markets, by inhibiting the flow of critically needed imported inputs, had contributed significantly to the decline in output in recent years, Mr. Weitz continued. However, it was also important for Guyana to reformulate its economic policies so as to emphasize the generation of domestic savings. Output had been adversely affected by the rigidity of official price policies, and he supported the implementation of price policies that would provide adequate incentives to firms.

An appropriate exchange rate policy was crucial to the restoration of the economy, Mr. Weitz suggested. Internationally traded goods amounted to an unusually high proportion of GDP in Guyana. Establishment of a realistic level for the exchange rate would improve both the structure of relative prices and the fiscal position, if appropriately restrained incomes and demand policies were pursued. With regard to domestic financial policies, it was urgent to bring the operations of the public sector under control; a sharp reduction in the level of public expenditure would be needed. The implementation of an economic program that included more reliance on domestic savings, a strong fiscal policy, and realistic financing policies would improve the Guyanese economy.

Mr. de Vries remarked that Guyana's economy was characterized by severe disequilibria. The overall deficit of the public sector had reached 62 percent of GDP in 1983, and there were large price distortions. He could, therefore, support the staff's recommendation that a fundamental change in economic policy was needed. It was encouraging that the authorities had become increasingly aware of the necessity of such a change. Nevertheless, the distortions were so considerable that, even if a fundamental change were made, it would take some time to see the effects. However, the earlier that action was taken, the better.

Mr. Kafka said that his authorities fully understood the Fund's policies; indeed, the Minister of Finance had been present during the Executive Board's discussion in June, and the authorities had been in close contact with the Fund since then. They would continue to avail themselves of the Fund's advice, even while they could not avail themselves of its financial assistance.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the appraisal contained in the staff report for the 1984 Article IV consultation.

Directors expressed great concern about the continued deterioration of Guyana's economic situation from the already critical point reached at the time of the previous Article IV consultation. They observed that the measures taken by the authorities in the fiscal and exchange rate areas in the past year, although constituting steps in the right direction, had been clearly insufficient to check the growing external and internal imbalances, which had now reached exceptional proportions. While noting that exogenous factors had contributed significantly to the country's economic difficulties, Directors were of the view that the economic crisis facing the country at present was in large measure the result of inadequate policies followed over several years.

Directors drew attention to the marked weakening in public finances. The overall deficit of the public sector was estimated to have reached more than 60 percent of GDP in 1983, and was expected to increase even further in 1984. Public sector deficits had been accommodated by an expansionary monetary policy, which, in turn, had resulted in the exhaustion of the country's international reserves and the accumulation of external arrears. Directors urged the authorities to adopt without delay the measures needed to redress the situation. Directors also underlined the urgency of securing a substantial reduction in public sector dissavings, and they believed that such an effort would be best focused on cutting back current spending substantially. The implementation of a prudent fiscal policy would be fundamental in helping the Bank of Guyana to achieve more adequate control over the expansion of credit and, thus, a halt to the loss of international reserves.

Directors pointed to the major distortions affecting the productive structure of the Guyanese economy, regarding them as a primary source of Guyana's present economic difficulties. They noted that far-reaching modifications were required in relative prices to restore adequate incentives to economic agents and to bring underground economic activities back to more normal channels. Directors urged the authorities to liberalize domestic prices and to adopt a realistic exchange rate policy. Such a policy was all the more urgent because it should facilitate early elimination of arrears to the Fund as well as to other creditors.

Directors made special reference to the substantial overall accumulation of external payment arrears, which had reached the equivalent of more than two years of exports. In particular, they expressed deep concern about the buildup of arrears to the Fund, and noted that the resumption of normal financial relations with donors and creditors would require the elimination of external payments arrears. In view of the magnitude of the imbalances and dislocation in the Guyanese economy, a comprehensive stabilization program would need to be supplemented by foreign concessional assistance, Directors observed. They reiterated their support for the provision of technical assistance by the Fund, if Guyana so requested.

It is expected that the next Article IV consultation with Guyana will be held on the standard 12-month cycle.

The Executive Directors then reviewed Decision No. 7719-(84/88), adopted on June 6, 1984, limiting Guyana's use of the Fund general resources until such time as the member was current on its obligations relating to repurchases and payment of charges (EBS/84/47, Sup. 4, 8/29/84).

The staff representative from the Treasurer's Department confirmed that a further payment of SDR 700,000 had been received that day from Guyana.

Mr. Kafka said that, as the Board was aware, his Guyanese authorities were deeply concerned about their inability thus far to repay the Fund and to keep all charges current. He agreed with the analysis of the problems and of the authorities' efforts presented in EBS/84/47, Supplement 4, and with the staff's recommendation.

Mr. de Vries remarked that, while he could support the proposed decision, one element deserved a somewhat different emphasis than it had apparently been given. As had been made clear in the preceding discussion of the staff report for the 1984 Article IV consultation, arrears amounted to about two years of exports and severe disequilibria continued to exist. It was normally a sign of cooperation if a country in difficulty gave priority to repaying the World Bank and the Fund. Guyana should adopt such an approach when allocating its available foreign exchange. Therefore, paragraph 2 of the proposed decision should not be taken to mean that the authorities had to adopt all the necessary adjustment measures before taking steps to become current in their payments to the Fund.

Mr. Mtei stated that he agreed with the staff's recommendation that Guyana should urgently adopt strong, effective economic and financial measures to bring its economy into proper shape so that it could become current in its obligations to the Fund as soon as possible. However, it was unfortunate that under present Fund policies the Fund could not come to the assistance of Guyana until the country was current in its obligations. For that reason, the Guyanese authorities should take all possible steps to become current with the Fund, including, if necessary, the arrangement of a bridge loan, so that they could then negotiate a comprehensive stabilization program that might include the use of Fund resources. The authorities generally agreed with the staff on the major actions to be taken. The Fund, as well as the World Bank, should be prepared to assist the country, which was potentially rich and well endowed, in overcoming its present difficulties; and friendly bilateral donors should be ready to assist Guyana generously during the interim.

Mr. Templeman observed that the present discussion was the second examination by the Executive Board of Guyana's arrears. Care should be taken, therefore, not to set inappropriate precedents. The procedures agreed at the time of the Executive Board's consideration of overdue payments to the Fund (EBM/84/54, 4/5/84) should be followed, while allowing for flexibility according to the individual circumstances of each country. His authorities regarded as positive the fact that Guyana was making some payments to the Fund. However, those payments did little more than maintain the existing situation, and the elimination of arrears was not being tackled in a fundamental way. The real problem was the inadequacy of policies, which were not permitting Guyana to generate the foreign exchange that would enable it to repay the Fund or to sustain the economy, as all Directors hoped. A comprehensive adjustment program was, therefore, necessary, although even the immediate adoption of such a program would take time to generate the required amounts of foreign exchange.

In those circumstances, Mr. Templeman continued, a further three months' extension of the review period following the three months that had passed since the previous decision might carry the disturbing implication that the Executive Board was not sufficiently concerned about the way in which the real problems were being handled. It was, therefore, worth considering whether the period until the next review might be less than the proposed three months. Another possibility was to consider what penalties might be imposed, with regard not only to Guyana but also to the general question of overdue payments. If a country had foreign exchange available, it might be useful to impose penalty charges so that the Fund would receive priority in the allocation of that foreign exchange. While there had not been widespread support for such penalty charges at the time of the Executive Board discussion of the issue in April, the Chairman had indicated in his summing up that the staff would look into the question; it would be useful to know if any conclusions had been reached. A further possibility was the use of special consultations. While it would not be appropriate to hold a special consultation immediately with Guyana because the Article IV consultation had just been completed, such an option should be borne in mind to encourage the prompt adoption of appropriate economic policies.

Mr. Nimatallah commented that it was encouraging that Guyana had been making a serious and continuing attempt to become current with the Fund. He welcomed the payment of more than SDR 2 million since June and the authorities' intention to pay a further SDR 9.5 million by the end of 1984. Equally important, the authorities were considering the adoption of adjustment measures designed, inter alia, to eliminate overdue obligations to the Fund. However, despite those efforts, Guyana's outstanding obligations had increased since June and, even if the authorities paid as planned, outstanding obligations would still amount to about SDR 16 million at the end of the year. The position fell short of the major progress that the Managing Director had hoped for in his letter to President Burnham in June. Therefore, the authorities needed to do more, notably to adopt a comprehensive adjustment program, which would help Guyana to handle its debt, including its obligations to the Fund, with less strain. Such action was all the more necessary, given the substantial obligations that would fall due in 1985 and beyond.

On that basis, he could support the proposed decision, Mr. Nimatallah concluded. However, if the authorities did not take appropriate action before the next review, there might be no alternative but to consider tougher sanctions. At the time of the Board's discussion on overdue payments to the Fund (EBM/84/54, 4/5/84), he had suggested the use of various sanctions. In view of the increasing number of countries falling behind in their obligations, the situation was becoming more serious than previously thought. It might be appropriate to reconsider the general question of sanctions, as Mr. Templeman had indicated, perhaps early in 1985.

Mr. Gomel stated that he was encouraged by Guyana's recent payments to the Fund; the announcement of a further schedule of payments to be made in 1984 was particularly important, and he could, therefore, support the proposed decision without amendment.

Mr. Grosche said that he joined other speakers in welcoming the authorities' intention to make further payments of about SDR 9.5 million to the Fund between September and December 1984. However, those payments would reduce the amount outstanding only slightly from the level prevailing when the Board had taken its decision in June. While it was important that the proposed payments should be made, he was inclined to favor Mr. Templeman's suggestion that it might be appropriate to review the situation earlier than November 30, 1984.

Mr. Leonard remarked that his chair strongly supported the manner of dealing with overdue payments to the Fund set out in the Chairman's summing up of the Executive Board's discussion on April 5, 1984. The moderation and understanding underlying that approach and their application to the case of Guyana were appropriate. The recommendation made by the staff in EBS/84/47, Supplement 4 was entirely in keeping with the spirit of current policy. He could, therefore, agree with a decision to continue to pursue the approach toward Guyana adopted in June and to review the matter not later than November 30, 1984. Nevertheless, he shared the concern expressed by other Directors about the proliferation of arrears, and he accepted that a time would come when stronger measures would have to be taken for those members that failed to honor their obligations to the Fund. He hoped that the Board's current approach would allow the Guyanese authorities to rectify their position in the additional time that would be afforded to them and that the necessity of stronger action would be avoided.

Mr. Malhotra noted that Guyana had made some payments to the Fund and was intending to make further payments. He could, therefore, support the proposed decision. He hoped that the Fund's management would be in touch with the Guyanese authorities so that the arrears could be eliminated.

Mr. Schneider said that he also welcomed the efforts by Guyana to reduce its overdue obligations to the Fund. He could support the proposed decision. He agreed with Mr. Nimatallah that it would be appropriate to have a further discussion on overdue payments and how the Fund should deal with them. At present, four countries were denied use of Fund resources as a result of overdue obligations, and other countries might soon be in a similar situation. Although a number of options were available to the Board under the Articles of Agreement, the forced withdrawal of members would be most unfortunate and contrary to the cooperative spirit of the Fund. Therefore, the Board should examine new ways to deal with the growing problem.

Mr. Donoso observed that a definitive solution to Guyana's arrears problem would require the adoption of a comprehensive set of adjustment measures, and he urged the authorities to move promptly in that direction. It was encouraging that Guyana had made payments of about SDR 2 million and that it intended to make further payments before the end of the year. On that basis, he could support the proposed decision.

Mr. Morrell said that he, too, could support the proposed decision, including the extension of the review period for a further three months. The payments that Guyana had made and that it intended to make were signs of good faith although they did not do much to reduce the overall arrears position. Therefore, the only real hope of improvement would be the implementation of significant economic measures. He hoped that the three-month extension would give the authorities time to take those measures, which the Executive Board could assess on the occasion of the next review. In the absence of substantive measures at that time, the Fund would have to consider what other options were available, even if further payments had been made along the lines envisaged.

Mr. Zhang, Mr. Senior, Mr. Salehkhou, Mr. Clark, and Mr. Juusela stated that they supported the proposed decision.

The staff representative from the Treasurer's Department commented that in making its recommendation, the staff had sought to strike a balance that would acknowledge the efforts being made by the Guyanese authorities while emphasizing that more needed to be done, with regard to both policy measures and payments to the Fund. It was open to the Executive Board to shorten the review period; however, the staff had been influenced by the fact that most of the further payments currently expected would be made by November, which would be a convenient point in time to assess the situation. A number of Directors had suggested that it would be useful to review more generally the matter of overdue obligations to the Fund. The staff was preparing the six-monthly report requested by the

Board in that regard, which should be available shortly; the report would provide an early opportunity to review what further possible steps might be taken to deal with the problem.

Mr. Templeman asked whether the Chairman would sum up the discussion.

The Secretary noted that under current procedures, in addition to summing up the Executive Board's discussion at the conclusion of Article IV consultations, the Chairman usually made a summing up of discussions in which Fund policies were established or reviewed. The subject under discussion at the present meeting related to the application of a recently established policy; it had not hitherto been the practice to sum up such discussions.

Mr. Templeman remarked that a summing up by the Chairman might nevertheless prove useful as a reflection of Directors' views on the present occasion.

Mr. Kafka said that he agreed with those Directors who had suggested that it would be useful to have a general discussion on arrears, as it would enable the Board to consider a wider range of options. He welcomed the recognition by Directors of the genuine efforts of his Guyanese authorities to make payments, although he understood that Directors were not wholly satisfied with the extent of those efforts. However, his Guyanese authorities had taken all possible steps available to them. They had informed him that they expected to earn about $50 million from exports by the end of 1984, of which about $9 million would be used for imported intermediate goods necessary for the sugar and rice industries, about $8 million for various services, and only $5 million for consumer goods. The latter category included no luxury items, but only the minimum basic necessities to feed the population. By far the largest portion of earnings would go to service debts, with the Fund receiving about $11 million--the largest single share--the World Bank about $5.6 million, and other creditors the remainder. If the authorities attempted to allocate more foreign exchange to debt servicing, their only option would be to reduce productive inputs, thereby reducing the productive and exchange earning capacity of the economy from even its current poor level.

Mr. de Maulde and Mr. Grosche said that, in light of Mr. Kafka's comments they could support the proposed decision.

The Chairman made the following concluding remarks:

> Executive Directors recognized that there had been a commendable effort by the Guyanese authorities to make some payments to the Fund, which they acknowledged as a positive development. However, great concern was expressed regarding the pace of those payments and about the fact that, even if the projected payments indicated by the Guyanese authorities were made, the level of arrears to the Fund at the end of 1984 would remain only slightly under the amount outstanding when the Executive Board considered

Guyana's case in June. The prospect that payments would only maintain overdue obligations at a level of about SDR 16 million was not acceptable, Directors emphasized, nor should the authorities consider it an adequate objective.

Although the view was expressed that, given Guyana's balance of payments situation, payments of SDR 9 million by the end of 1984 represented a serious effort, the opinion of the Board was that payments in that amount would clearly be insufficient to restore normal relations between the member and the Fund. More would have to be done. In that regard, Directors stressed the need for the Guyanese authorities to address their fundamental problems without delay. While that did not mean that all detailed policy action would have to be taken before the Fund was paid, a comprehensive program of adjustment was clearly indicated if Guyana was to become and remain current on its financial obligations to the Fund and if, therefore, active cooperation between Guyana and the Fund was to be resumed. Such a program, which could not at the outset be the basis for financial assistance from the Fund, could be drawn up along the lines suggested by the staff in its report for the 1984 Article IV consultation (SM/84/158, 7/5/84) and would contribute to the provision of other external finance. The Fund would stand ready to provide technical advice in the design of specific aspects of such a program.

A number of Directors raised questions concerning the adequacy of the existing procedures to ensure timely payment to the Fund, not only in Guyana's case but more generally. Some suggested that the Fund should explore the possibility of imposing penalties that might induce countries to make payments to the Fund a higher priority than payments for other purposes. Other possible steps were also suggested. In the particular case of Guyana, the concern of the Board was manifested in the fact that some Directors believed that greater pressure should be brought to bear by shortening the period suggested by the staff for further review of the matter. However, it was agreed to accept the staff's recommendation to review the position again not later than November 30, 1984.

The Executive Board then took the following decision:

1. The Fund has reviewed Decision No. 7719-(84/88), June 6, 1984, in light of the discussions between the Fund and Guyana, the recent payments made, and the payments proposed to be made, as described in EBS/84/47, Supplement 4 (8/29/84).

2. The Fund calls upon Guyana to adopt urgently additional economic and financial adjustment measures and to become current on its financial obligations to the Fund.

3. The Fund shall further review Decision No. 7719-(84/88) not later than November 30, 1984.

Decision No. 7792-(84/131), adopted
August 31, 1984

2. SDRS - ALLOCATION

The Executive Directors considered a staff paper on the allocation of SDRs in the fourth basic period (SM/84/191, 8/3/84; and Cor. 1, 8/29/84). They also had before them a paper on the legislative history of the concept of global need to supplement existing reserves through the allocation of SDRs (SM/84/148, 6/27/84).

Mr. de Maulde remarked that the staff had clearly demonstrated by its analysis in SM/84/191 the existence of a long-term global reserve need, without using complicated formulas that would only have weakened its case. The staff had also given a convincing response to the principal questions raised by Directors during the numerous discussions that the Executive Board had held on the subject. However, the staff had not followed the logic of its own arguments when it had suggested that a reasonable allocation would amount to about SDR 10 billion a year. There was a clear case on macroeconomic grounds for an allocation of at least SDR 30 billion over the two remaining years of the fourth basic period.

In the note that he had circulated,1/ Mr. de Maulde continued, he had sought to address the problem that SDR allocations met reserve needs in a somewhat indiscriminate way by allocating more SDRs to those who needed them less, and vice versa. The contradiction could be solved in two ways. The simplest solution would be to decide on an allocation large enough to provide many heavily indebted countries with significant increases in reserves. In those circumstances, other members might fear that they would be called upon to accept too large a proportion of SDRs at a later date, but such apprehensions could be dealt with through the reactivation of the reconstitution obligation, which would also help to deal with the feared monetary consequences of a large allocation. The alternative, more imaginative, solution was similar to the proposal put forward earlier by Mr. de Groote (EBM/84/45, 3/26/84), differing primarily in that under his own proposal the industrial countries would be the lenders rather than, as in Mr. de Groote's proposal, the Fund. In that way, complex parliamentary difficulties could be avoided and the basic thrust of Mr. de Groote's suggestion could be made more practicable. Conditionality could be maintained through a link with the Fund's

---

1/ Reproduced in Annex.

surveillance function, perhaps similar to the arrangements that were being considered for the multiyear rescheduling of Mexico's debts. His authorities could accept either solution, although they preferred the second.

Mr. de Groote recalled that, during previous discussions of an allocation of SDRs in the fourth basic period, a large majority of the Executive Board had considered that an allocation would be in full conformity with the requirements of the Articles of Agreement. The staff provided further and stronger arguments in favor of that view in SM/84/191, particularly by showing that the ratio of reserves to international trade would decline markedly if the base scenario outlined in the current World Economic Outlook was realized, which would lead to an increased global demand for reserves during the remainder of the fourth basic period. The staff had also shown that the share of SDRs in non-gold reserves would continue to decline in the absence of an allocation and that the possibility of such a trend being offset by the acquisition of borrowed reserves no longer existed to the same extent as previously. The conclusion was inescapable that the views of those Directors who favored an allocation had been reinforced by the staff's most recent analysis.

It was possible to interpret some of the staff's work differently, Mr. de Groote continued. The argument that the proposed allocation was so small that it would contribute neither to a rekindling of inflation nor to laxity in the adjustment process might also be taken to mean that there was little reason to favor an allocation, which had to be based on a verifiable global reserve need. On the other hand, if it was feared that an allocation might endanger the adjustment process, why should the possibility that an allocation might directly contribute to better adjustment not also be considered?

The discussion of an allocation in the fourth basic period had thus far been confined to the possibility of implementing an existing scheme in a mechanical fashion, Mr. de Groote considered, without raising questions about the role of such a scheme in the functioning of the international payments system. The time had come to spell out the role of the SDR in relation to reserve currencies in the type of system that had evolved since the Second Amendment of the Articles of Agreement and the function of an SDR allocation in relation to the adjustment process. On previous occasions, the U.S. chair had raised pointed questions in that regard. Unless the issue was faced, there was little prospect that a further discussion of an allocation would go much beyond the repetition of conflicting points of view. The question was now at the political level where progress was only possible if new approaches were considered. The least attractive option would be to attempt to establish a trade-off between access to Fund resources and an SDR allocation without trying to examine the latter in a new light.

Commenting on Mr. de Maulde's note, Mr. de Groote said that its objectives deserved strong support. The proposal to direct the allocation to countries where there was a need for additional liquidity, in the context of a Fund appraisal of the economic policy of members, had much in common with his own proposal put forward at EBM/84/45. However, Mr. de Maulde considered that an important difference between the two proposals was that his idea would "probably" avoid the need for parliamentary approval because it involved lending to member countries, a possibility already allowed for in the Articles of Agreement. In the five countries of his own constituency, lending SDRs in the way suggested by Mr. de Maulde would be possible without parliamentary approval. But although he understood that the U.S. Exchange Stabilization Fund, which would receive an allocation, could lend SDRs to the monetary authorities of other countries in short-term swap operations for up to a maximum of three months, it might be difficult to regard the continuous renewal of such swaps as a short-term operation. Irrespective of the legal requirements, it would be surprising if a responsible government did not seek parliamentary approval for a scheme that in substance represented precisely the case for which approval was required.

Because he considered that his own scheme was similar to Mr. de Maulde's with regard to the need for parliamentary approval, Mr. de Groote went on, he preferred to move toward their shared objective through a more straightforward solution that would permit a possible change in the role of the SDR and of the Fund. In that respect, Mr. de Maulde's proposal sought to add an attractive feature to the existing process of SDR allocation, assuming, of course, that agreement could first be reached on such an allocation. His own earlier proposal could be regarded as covering a situation in which there was no agreement on a traditional type of allocation but a clear global need for additional reserves as evidenced by the inadequacy of Fund resources to finance appropriate adjustment programs. Under Mr. de Maulde's proposal, conditionality was an attractive extra feature of a decision that would have to be justified on its own merits; under his own proposal, conditionality was the raison d'être of the envisaged allocation.

Some other differences between the French and the Belgian proposals were worth consideration, Mr. de Groote suggested. Mr. de Maulde had indicated that under his scheme developing countries would have to accept conditional SDRs, although only those re-lent by industrial countries, which, he had implied, represented a difference from the Belgian proposal. In other words, developing countries would keep their own allocation. However, that eventuality had been explicitly envisaged in his own proposal, in which he had left open a variety of options in that regard. As he had stated at EBM/84/45:

> The scope of this agreement would vary according to whether all or only some of the participants would place all or a part of their allocations at the disposal of the Fund, which could then onlend these additional resources to countries submitting to adjustment programs. The range of options could extend from the extreme case where all members would lend the totality of their allocation to the Fund for conditional use, to the other

> extreme under which only a group of countries would lend a part of their allocation for conditional use, while another group would freely use its allocations. Obviously, all these options have different implications for the distribution of the newly created international liquidity and for the associated adjustment efforts.

His personal view had always been that the best solution would be for only industrial and oil producing countries to lend their allocations to the Fund.

The proposal by Mr. de Maulde aimed at ensuring that an allocation, which he hoped would be large, would be used to enable developing countries to build up their reserves, Mr. de Groote noted. Could that aim not be achieved by limiting the proposal to a reintroduction of the reconstitution obligation? If reserve rebuilding rather than support for the Fund's role in promoting adjustment was the aim, that solution was the most obvious. Mr. de Maulde also believed that his system had the advantage of simplicity. However, it would not be simple for all lending members to have to register every drawing on their accounts in amounts that would frequently be small and fractional. Although computers could do much of the work, central banks would not welcome the complexity of keeping track of all transactions. One of the clearest merits of his own proposal was that it left unchanged the present system and, in particular, the present accounting procedures for drawings and the rules for repurchase obligations.

The Fund's judgment underlying the use of an allocation available for lending required, in Mr. de Maulde's proposal, an appraisal of an individual country's need for reserves, Mr. de Groote commented. However, it might be difficult to develop criteria for evaluating such needs on a case-by-case basis. If the Fund were allowed to use part or all of the allocation to finance drawings in the usual manner, no new criteria for the use of Fund resources would have to be adopted. His comments on the proposal should not be interpreted as disagreement with Mr. de Maulde's objectives. It was particularly heartening that the aim of adapting an SDR allocation to the current needs of the international system was gaining ground in the Executive Board.

At the request of the Chairman of the Deputies of the Group of Ten, the Director of the Legal Department had submitted an interesting opinion on the Belgian proposal, Mr. de Groote said. His initial reaction had been that it would not be necessary to circulate that opinion to Executive Directors at present in order to avoid confusing the issue of a traditional allocation--a matter that should be taken up at the Annual Meetings--with a proposal that was more appropriate to a general discussion of the reform of the Fund. However, given that an alternative proposal had now been put forward, he would be happy to circulate the opinion of the Director of the Legal Department to Executive Directors and to the Group of Ten, if Directors thought it would be useful. In any case, he would prefer not to transmit to the Group of Ten a document that had not been circulated to the Executive Board.

Mr. Polak remarked that the projected medium-term growth of reserves broadly in proportion to the medium-term growth of world trade presented incontrovertible evidence that the global need for reserves was increasing. The fact that reserves, including reserves of the non-oil developing countries, had resumed their growth in the past few years in the face of extremely difficult external circumstances for many countries provided further evidence of the importance that countries attached to having an adequate supply of reserves. Those macroeconomic considerations with regard to the international system as a whole were fully supported by the micro-economic considerations that the Executive Board took into account in discussing the adjustment policies of individual countries.

The global need for reserves had been met entirely from sources other than SDR allocations in 9 of the preceding 12 years, and about 85 percent had been met from other sources during the other 3 years, Mr. Polak continued, which provided clear evidence that it was possible for the system's reserve needs to be met without SDR allocations. The question remained whether that situation was desirable. Having established the SDR mechanism, would it not be better to use it? The first issue was whether the fact that a global need could be satisfied by reserves in other forms allowed the Fund to proceed to an allocation. The staff had faced the issue for about a decade and had dealt with it extensively in the papers prepared prior to the 1978 decision to allocate; the case had been restated in SM/84/148. It might be considered that the Board had implicitly endorsed the staff's view when SDRs had been allocated in 1979-81. However, so many factors had entered into that decision that such an inference could not be taken for granted. In the view of various authorities, including his own, there remained important reservations with regard to the existence of the need required by the Articles, if it was admitted that that need was not inescapable.

The staff correctly referred to the advantages that allocated SDRs had over borrowed reserves or over reserves acquired through excessively harsh adjustment, Mr. Polak observed, and it was worth emphasizing that those advantages benefited the system as well as individual members. Whatever the arguments in favor of an allocation, the size would obviously have to be constrained by the overriding importance of the adjustment process, which an allocation ought not to impede.

It was difficult to believe that the SDR system could survive without allocations, causing SDR holdings to become an increasingly smaller portion of reserves, Mr. Polak said. He hoped that even those Directors who were not greatly impressed by the substance of the arguments in favor of an allocation would find it possible to support a decision to allocate at present, as they had done in 1978, if for no other reason than to keep the SDR system alive. Although views within the Executive Board differed on the present functioning of the international monetary system based on national currencies, he doubted whether all Directors were so satisfied with the system that they would want to preclude the possibility that international reserves deliberately created by a decision of the Fund might play an important role in the future. On the basis of the preceding general considerations, he could support a decision on SDR allocations to begin on January 1, 1985.

Given the differences of view that had manifested themselves on previous occasions, Mr. Polak went on, a positive decision to allocate would be possible only if the annual amount were modest. Furthermore, the evidence from past allocations suggested that a considerable portion of the SDRs allocated tended to gravitate toward the reserves of a few industrial countries with balance of payments surpluses. Some of those countries would not welcome the significant reduction in their holdings of reserve currencies as a consequence of large designations. A modest allocation would be compatible with the staff's observation that an annual allocation of about SDR 4 billion would maintain the present ratio of SDR holdings to non-gold reserves.

The staff had not discussed the number of years in which allocations should be made, Mr. Polak noted. It had assumed that the period would be two years--the remainder of the fourth basic period. However, the Articles of Agreement did not commit the Fund to limit allocations to that accidental two-year period. In any event, the Executive Board should take a positive decision on the appropriate period of allocation; he believed that two years might be too short to meet the long-term global need referred to in the Articles. First, following 9 years in the last 12 without allocation, and two previous decisions to allocate for 3 years in succession, a decision at present to allocate for only 2 years would appear less than robust. Second, such a decision would force the Executive Board to consider the question of allocation for the next basic period in early 1986--about 18 months away. If there was to be a real possibility of achieving agreement on an allocation in the next basic period, more time would be required for Executive Directors to take up the question from a fresh perspective.

Mr. Nimatallah suggested that the time was ripe to take a positive decision on resuming SDR allocations in the fourth basic period. The case for resumption had strengthened in recent months. The world economic recovery was under way and was becoming more widespread after a period of stagnation. The value of world trade was rising rapidly and should continue to rise in the medium term. The growth in trade and financial transactions would have to be financed by a commensurate growth in reserves. The staff projected that the SDR value of international trade would grow at an annual rate of 10 percent or more from 1984 onward. Given that non-gold reserves had been falling, they would have to grow by about SDR 150 billion in 1984-86. Even beyond 1986, the expansion of global trade would require a steady growth in reserves. The staff concluded that "to function smoothly, the international monetary system must efficiently satisfy this long-term rise in demand in order to avoid the effects of a global reserve shortage." He agreed with that view.

Two important questions needed to be answered in that regard, Mr. Nimatallah continued, namely, where would the increase in reserves come from and what could the Fund do to help members to generate reserves? Adjustment was a difficult and time-consuming process that could generate only limited amounts of reserves. Another approach was to borrow from international capital markets, but that might also be difficult for many countries at present. A third method was through changes in official intervention in foreign exchange markets, but that option was a privilege limited to certain countries. In short, the system could not at present satisfy the rising demand for reserves; the existing global shortage of reserves was, therefore, likely to continue and to increase.

The Fund, as the world's central monetary institution, had a responsibility to help the system, Mr. Nimatallah considered. Until the present, the Fund had helped members to generate reserves through adjustment. However, the adjustment process was moving from the first stage of reducing imports to the second stage of expanding exports in order to acquire reserves. The expansion of exports required an increase in imports, which in turn drained the acquired reserves. The central issue was that growing trade, which was vital to economic growth, required growing reserves. The Fund could and should supplement reserves by resuming SDR allocations at once. Allocations, which should continue without interruption in the future, would help to ensure that adjustment, expanding trade, and economic growth proceeded together without interruption.

There had been two main apprehensions concerning allocations, Mr. Nimatallah went on: that they could slow adjustment or trigger inflation. Both issues had been handled well by the staff. There was no evidence to support either apprehension, particularly if allocations were modest. Mr. de Maulde's proposed "modest" allocation appeared quite large; although the amount might be modest in relation to outstanding debt, the size of such debt was not the appropriate consideration. The connection between allocations and debt repayment was more indirect; it was related to the financing and expansion of trade to promote economic growth, which would, in turn, help the repayment of debt.

The most important aspect of Mr. de Maulde's proposal was his attempt to go beyond the question of resuming SDR allocations to the more fundamental issue of redistributing SDRs in such a way as to limit the size of allocations, Mr. Nimatallah considered. If he understood Mr. de Maulde's proposal correctly, it sought to channel extra SDRs from those members who did not need them to those who did at a certain period of time. It was in a sense a supplement to the capital markets through which members could enhance their borrowed reserves. The objective was commendable, and the proposals by Mr. de Maulde and Mr. de Groote for the size of new allocations and the length of the basic period were useful. Other important questions, such as repayment provision, the designation process, and acceptance limits, would also have to be addressed.

Under either scheme, borrowers would have to pay two prices: the interest rate on borrowed SDRs compared with owned SDRs, and conditionality, Mr. Nimatallah remarked. It might be argued that, if members did not have access to capital markets, those prices were not high. However, countries that had alternative sources of finance might choose not to take advantage of the process. At present, he was not able to indicate his authorities' position on the details of either proposal, but if proposals along those lines contributed to the early resumption of SDR allocations, his authorities would not hesitate to support them. The final point made by Mr. de Maulde with regard to the reconstitution obligation raised important legal and other issues that would require further time to address. Finally, the resumption of SDR allocations would strengthen the SDR as an important reserve asset. The instability inherent in the present mechanisms for creating international liquidity would thereby be reduced.

Mr. Lovato said that his views on an SDR allocation did not differ significantly from those he had expressed at the previous Executive Board discussion of the question. Indeed, they had been reinforced by the staff's arguments in support of an allocation, inasmuch as it would provide part of the required increase in non-gold reserves.

With regard to the global need to supplement existing reserves, Mr. Lovato continued, the staff's analysis of recent developments in international liquidity and the prospective requirements in the remainder of the fourth basic period was convincing. A reserve shortage could reasonably qualify as "global" if it was sufficiently widespread to be considered "systemic." The benchmark was not the liquidity situation in individual countries or groups of countries but the adequacy of reserves for the functioning of the international monetary and trading system. In that respect, symptoms of reserve stringency had surfaced to a significant degree in a large number of countries, particularly capital-importing developing countries; the staff correctly pointed to indicators of that growing trend, such as import restrictions and payments arrears, and noted no evidence of excess reserves in other countries.

In addition to the existing reserve shortfall, Mr. Lovato remarked, there was the question of the long-term growth in world demand for reserves related to the anticipated expansion of international trade and financial flows. The considerations mentioned by the staff--that conventional projections of the demand for reserves tended to be biased downward because of developing countries' shrinking access to credit markets and borrowed reserves--were valuable. By helping to rebuild debtor countries' reserves and improving their credit standing and ability to borrow in international capital markets, an allocation would be of indirect benefit to virtually all countries, including those that did not suffer from a reserve shortage. A response to the debt problem in the form of an allocation intended to strengthen debtor countries' reserve positions would be wholly appropriate, especially in view of the large role that developments external to those countries and independent of their policy stance had played in precipitating their debt servicing difficulties.

Commenting on the size of an allocation, Mr. Lovato remarked that an allocation could satisfy part of the required increase in reserves to meet a demonstrably large need, which was partly immediate--stemming from the existing shortage--and partly longer term--due to the trend growth of the shortage. It should not be assumed that other forms of reserve accretion would not be available in the next two years. He agreed with the staff that no allowance should be made for future inflation in determining the rate of SDR allocation, but he did not believe that the rate of increase of SDRs should match real import growth. Instead, he favored an allocation of SDR 10 billion in each of the coming two years.

A decision on the desirable rate of SDR allocation was constrained by the assessment of its impact on inflation, the adjustment mechanism, and on the composition of reserves, Mr. Lovato stated. SDR allocations were not inflationary if the newly created reserves were willingly held, so that the resulting growth in reserves was no greater than the increase in the demand to hold them. Reserves had been compressed as an outcome of anti-inflationary policies; they should be restored to more normal levels without rekindling inflation. In the current environment of low inflation and monetary restraint, there was no reason why the markets should misinterpret SDR allocations as an indication of easier monetary policies and thereby revise upward their expectations of future inflation.

It was unlikely that limited allocations could impair countries' compliance with the adjustment policies advocated by the Fund, Mr. Lovato said, because conditional and semiconditional lending had increased significantly in the recent past. On the contrary, as the staff pointed out, an accumulation of reserves beyond the level generated by current account surpluses could give further impetus to the adjustment process. Finally, the composition of international liquidity ought not to be the criterion governing an allocation decision. It was clear, however, that market mechanisms were not adequate to regulate liquidity creation and that the lower ratio of borrowed to total reserves that would result from an allocation would be a desirable development in the international monetary arena.

Mr. Senior noted that his chair had expressed its support on a number of occasions for the SDR system in general and for an SDR allocation in the fourth basic period, in particular. The information and analysis in SM/84/191 had strengthened his belief in the urgent need for a resumption of allocations. The staff arguments in favor of an allocation were incontrovertible. Most important, they were in full compliance with both the legal requirement and the spirit of the Articles, as clearly demonstrated in SM/84/148.

The existence of a global need for reserve supplementation did not require that every country should have a specific reserve need, Mr. Senior continued. In that respect, it was somewhat puzzling that some national authorities referred to the external debt crisis facing many countries as a serious threat to the stability of the world monetary system while denying that the liquidity problems of those and other countries indicated a global need for reserves and liquidity in the world economy.

The current and prospective working of the international adjustment mechanism pointed to the need for an injection of international liquidity to facilitate international trade, Mr. Senior considered. The staff provided clear evidence of the emergence of a growing gap between the global demand for international reserves and liquidity and the capacity of the system to supply those reserves through the monetary policies of key currency countries. Moreover, the adequacy of reserves could not be evaluated solely on the basis of quantitative ratios provided by reserve movements. It was also necessary to look at other evidence that was not easily quantifiable but was qualitatively important, such as the distribution of the burden of international adjustment among countries. There appeared to be general agreement that the current adjustment process was highly deficient: it placed too heavy a burden on countries' imports while their exports were constrained by protectionist pressures, and the countries' access to international capital markets to smooth out their adjustment was practically nonexistent.

The process of adjustment of most developing countries toward a viable external debt position could be considerably improved if SDR allocations were resumed, Mr. Senior concluded, not so much because of the quantitative impact of those allocations as because of the positive effects that they could have on the confidence of major creditors and debtors. Allocations would demonstrate that mechanisms were available to the international community that could be set in motion in times of crisis.

Mr. Grosche recalled that his authorities had emphasized on many occasions that the long-term global need to supplement existing reserves was the sole criterion on which to base a decision to allocate SDRs and that other criteria could only be auxiliary arguments. The papers before Directors confirmed that view. The staff stated clearly that the global need for reserve supplementation was the sole criterion. Other criteria, for example, the unsatisfied demand for reserves on the part of individual countries or the desire to make the SDR the principal reserve asset, had rightly not been put forward as arguments for allocations. He also welcomed the staff's clear statement that SDR allocations should not be used for "countercyclical" purposes or in an attempt to achieve "fine-tuning" of world demand. The staff's argument on page 3 of SM/84/191 that reserve supplementation would presumably be judged to be "needed" if it could be expected to improve world economic conditions was less convincing, because it did not refer to the point that the need required a shortage of reserves, or at least a potential shortage. Another condition would have to be fulfilled; unlike the staff, he believed that an allocation of SDRs should only be made if the global need could not or would not be met in other ways.

In considering the long-term global need, the staff was of the opinion that a number of broader objectives had to be taken into account, Mr. Grosche continued. It mentioned in particular the Fund's obligation to aim at avoiding inflation or deflation in the world economy when deciding on SDR allocations. Perhaps he had misinterpreted the staff's argument, but in light of Article XVIII, Section 1(a), those broad objectives mentioned by staff were not relevant in examining the long-term global need. They were only relevant, as and when the need arose, to determine the manner in which the long-term global need should be met.

With regard to the second issue taken up by the staff--the growth of reserves and international liquidity--he agreed that the adequacy of international liquidity could not be quantified precisely, Mr. Grosche said.

Although the staff had made a commendable effort, its review of recent movements in non-gold reserves did not provide new information that could make a convincing case for allocating SDRs. The staff stated that indicators of reserve inadequacy might also reflect the inappropriateness of past policies, a point with which he fully agreed. If, however, that view was correct, there was a need for conditional liquidity rather than unconditional SDRs, particularly because the amounts that could be provided through an SDR allocation to the countries in question were rather small. The staff assumed an allocation of SDR 10 billion--a large amount indeed--and came to the conclusion that such an allocation would increase the SDR holdings of the group of countries with Fund-supported programs by approximately SDR 1 billion, which represented a small amount compared with the SDR 13.7 billion already committed by the Fund to those countries. If there was a reserve inadequacy in many countries as a result of the inappropriateness of past policies, conditional liquidity through Fund-supported programs was the best way to deal effectively with both the economic problems and the inadequate level of reserves.

The staff's calculations with regard to the long-term global need for non-gold reserves were based, first, on the re-establishment of the average ratio of reserves to imports for the period 1970-83--21.7 percent--and second, on the assumption of a 10 percent increase in world trade until the end of 1986, Mr. Grosche noted. Under those assumptions, the staff calculated that the level of non-gold reserves for the end of 1986 would have to rise to SDR 508 billion. However, the calculations were based on only one set of possible assumptions. On previous occasions, his chair had questioned the appropriateness of using the ratio of reserves to imports, but even if it was applied, other reasonable calculations that produced different results could be made. For example, calculations based on a ratio of reserves to imports of 17.4 percent--the ratio in 1970 before the rapid expansion of reserves in the early 1970s--would lead to a level of reserves about SDR 100 billion lower than currently suggested. The staff admitted that it was difficult to choose an ideal reference period, but the period from 1970 to 1983 did not appear to be ideal. It had been marked by high inflation and volatility of world economic developments, features that he hoped would not be repeated.

On the size of SDR allocations, Mr. Grosche observed that the staff had repeated in SM/84/191 a conclusion that it had reached in SM/84/148, namely, that an allocation need not be ruled out simply because the global need could or would be met in other ways. His authorities considered that that line of reasoning was in accordance with neither the spirit underlying the creation of the SDR nor the relevant provisions in the Articles of Agreement. It was a general shortage of liquidity that could not be met by sources other than the SDR that justified an SDR allocation.

Prior to the allocation of SDRs in the first basic period, Mr. Grosche recalled, there had been growing concern that the world economy could be impaired by insufficient growth in international reserves. The rationale behind an SDR allocation had been summarized by Sir Joseph Gold in 1970 in Special Drawing Rights: Character and Use (IMF Pamphlet Series No. 13, p. 16): "It is a general shortage of unconditional liquidity which must guide the Fund in reaching a decision on whether or not to generate special drawing rights." When the allocation of SDRs in the third basic period had been considered, attempts had been made to dilute the argument that there had to be a general shortage of liquidity--even if it was only a potential shortage--because international capital markets had been highly flexible at that time. Those attempts had been reflected in the Executive Board's report to the Board of Governors that the decision to allocate special drawing rights did not depend on a finding that the long-term global need could not be met except by allocation. His authorities had never subscribed to that reasoning. The final agreement on a second round of SDR allocations in 1978 had been part of a package deal in which the quota increase had played the major role. The decision to allocate SDRs had been the result of a political compromise, and the report by the Executive Board to the Interim Committee in preparation for that decision had made it clear that not all Directors had subscribed to the underlying rationale of that compromise.

The staff's conclusion that an allocation of SDRs could be made even if the need could or would be met in other ways placed too much emphasis on the demand for reserves while neglecting the supply side, Mr. Grosche considered. Whether or not the requirement of a global need might be met was a matter of judgment, but in assessing the adequacy of reserve growth, both demand for and supply of reserves had to be taken into account.

Because the case had not yet been made for an allocation, Mr. Grosche went on, he would not comment on the amount that might be allocated. For the same reason, he would refrain from commenting on Mr. de Maulde's note. He agreed with the staff that at present a moderate allocation of SDRs would be unlikely to have a major detrimental impact on inflation and inflationary expectations. He also agreed that there was no precise answer to the question of whether an SDR allocation would impair the commitment to adjustment. Nevertheless, past experience had not been promising, as demonstrated by the limited willingness of a significant number of countries to hold SDRs.

In view of the preceding considerations, Mr. Grosche considered the role of the SDR in non-gold reserves irrelevant as a justification for an SDR allocation. The staff argued that the objective of Article VIII--to make the SDR the principal reserve asset--would be difficult to reconcile with an extended decline in the share of SDRs in non-gold reserves. He could not support that line of reasoning. A decline in the share of SDRs was merely the result of an international monetary system that had not been working toward the more effective control of international liquidity. It was precisely that idea that the drafters of Article VIII, Section 7, and Article XXII had had in mind when referring to the objective of making the SDR the principal reserve asset of the system.

Finally, he assured Directors that his authorities recognized the important contribution that the SDR as a monetary asset could make toward the stability of the international monetary system, Mr. Grosche stated. They believed that well-considered decisions on the allocation of SDRs, fully conforming to the letter and the spirit of the Articles, were essential to exploit the full potential of that instrument. They also believed that the staff had not made a convincing case for an allocation in the papers prepared for the present discussion. However, they were fully prepared to keep the matter under review and to do so in close cooperation with all members and with the management of the Fund.

Mr. Malhotra commented that, if Mr. Grosche's line of reasoning were pursued to its logical extreme, there might never be a case for an SDR allocation. Mr. Grosche had agreed with the staff that it was difficult to quantify precisely the need for reserves and that, if the system of creating SDRs did not exist, the need for reserves in the global economy would be met in one way or another. The reasoning that SDRs should not be created if potential need for increment liquidity could somehow be met did not permit a balanced interpretation of the Articles of Agreement as a whole. While it might be appropriate to attach greater importance to one Article rather than another, it would not be proper to ignore some parts of the Articles completely. It was, however, reassuring that Mr. Grosche had indicated his authorities' support for the spirit as well as the letter of the Articles.

The Articles clearly envisioned that the SDR should become an important element in world liquidity, Mr. Malhotra continued. Of course, there also had to be a long-term global need for reserve supplementation, but part of the rationale for the SDR as a form of internationally created liquidity was the dissatisfaction that had been felt with excessive reliance on the budgetary and monetary policies of a few nations for the creation of world liquidity. Therefore, the goal of the SDR becoming the principal reserve asset in the system deserved emphasis.

The staff had provided an excellent analysis of the global reserve situation, Mr. Malhotra considered. World trade was expected to grow, with a consequent need for an increase in reserves, at least part of which should be met through the creation of SDRs. He endorsed that conclusion. Furthermore, if a large number of countries did not have adequate reserves, world trade was bound to be adversely affected. That consideration would also justify an allocation.

The argument was advanced that an SDR allocation would add only marginally to world reserves and that the question, therefore, was not very important, Mr. Malhotra observed. By the same token, an allocation would not have adverse consequences. It had to be pointed out that a large body of world opinion favored an allocation, even though the countries concerned did not yet command the majority in the Fund required for an allocation. The staff had provided enough technical studies to afford a basis for an allocation. It was time for the issue to be resolved at the political level, and he urged Directors to convey to their authorities the need for a positive decision in favor of an allocation. As for the size of an allocation, the Group of Twenty-Four had made a strong case in favor of at least SDR 15 billion in each remaining year of the fourth basic period; he supported that position.

Commenting on Mr. de Maulde's note, Mr. Malhotra remarked that it resembled in certain key respects the suggestions put forward on other occasions by Mr. de Groote. Although he appreciated that Mr. de Maulde and Mr. de Groote were seeking to promote an allocation, he could not accept the concept of conditional SDRs. An allocation that carried with it the notion of conditional use would be against the very nature of the SDR. Similarly, he could not accept the suggestion that the reconstitution provisions should be revived. Those provisions had been dropped because they had been found to be impracticable. Finally, he supported Mr. Polak's proposal that a longer period than the two remaining years of the fourth basic period should be considered for allocations.

Mr. Kafka said that the staff's analysis showed that the question of whether there existed a global need for reserve supplementation was, in the final analysis, a matter of judgment and that no precise guidelines were laid down in the Articles of Agreement to arrive at that judgment. However, various criteria were relevant, and they pointed to the existence of a global need to supplement reserves. One criterion was the development of reserves in important groups of countries. According to the data presented by the staff, the 20 countries with the largest external debt service payments had suffered a decline of more than one third in the ratio of reserves to imports between 1978 and 1983. In 1983, the ratio had been lower than in any year since 1970 except 1975 and 1982, which had both been years of recession. The failure to improve the reserve needs of those important countries would not only continue to condemn them to their reduced degree of economic performance, but also deprive the world of the contribution that they could make to the sustainability of recovery in the rest of the world. The fact that SDRs had not been allocated before the present stage of the fourth basic period was no reason to delay an allocation further.

The Fund also had to take into account the composition of reserves, Mr. Kafka continued. In a period of uncertain, weak recovery, excessive reliance on borrowed reserves by the non-oil developing countries posed a major danger to the recovery of those countries and to their contribution to world recovery. Borrowed reserves could disappear easily if a panic occurred among lenders, as had happened following the 1982 debt crisis. In addition, holding borrowed reserves was expensive, so that reliance on them placed an extra burden on countries already damaged by high interest rates. In any case, borrowing was not available to many countries as a means of building up their resources because their creditworthiness had not been re-established, or had been re-established only to the extent necessary to allow them to borrow what they needed to supplement their nonfactor current account surplus to pay interest. To rely on an uncertain means to meet the global need for reserve supplementation when a more reliable means was available would imply delinquency on the part of the Fund. Furthermore, even owned currency reserves were not ideal, because they were the result of lax balance of payments policies in some countries or excessively harsh adjustment measures in other countries.

The Articles provided that the SDR was to be made the international monetary system's principal reserve asset, Mr. Kafka said, which required a gradual increase in the share of SDRs in global reserves, even if it was accepted that SDRs could not be created simply for that purpose when no global need to supplement reserves existed. Moreover, privately issued SDRs could not substitute for SDRs allocated by the Fund because such action would be contrary to the intent of the Articles of Agreement and because SDRs issued by the Fund had characteristics that the privately issued SDR could not have; in particular, the volume of Fund-issued SDRs was under international control.

As several other speakers had pointed out, there was no danger at present that a reasonable allocation of SDRs would have an inflationary impact, Mr. Kafka went on. If it was necessary to assuage fears of sending an inflationary signal, it would probably be possible to obtain a sufficient majority in the Fund in favor of a reasonable reconstitution obligation. However, the time was not right to take up Mr. de Groote's and Mr. de Maulde's suggestions.

The growth of reserves in present circumstances could appropriately be less than the projected growth of the volume of world trade, Mr. Kafka remarked, which would probably not be in excess of 5 percent a year over the next few years. The annual allocation of SDRs should, therefore, be less than 5 percent of the present volume of international reserves, including gold at an agreed valuation, depending on the expectation of the extent to which other sources of reserve growth were likely to be available, and on the extent to which reliance on those sources was advisable. He strongly supported the resumption of allocations, beginning in 1985, for a reasonable number of years, not necessarily only the two remaining years of the fourth basic period.

Mr. Tshishimbi suggested that, on the basis of the staff's projections for the world economy in the remainder of the fourth basic period, an allocation of SDR 25 billion in 1985 and in 1986 would have been fully justified. Such allocations would meet the real demand for reserves during that period and, therefore, would not be inflationary. However, he could support the position of the Group of Twenty-Four in favor of an allocation of SDR 15 billion a year for the remainder of the fourth basic period, as well as the proposal that allocations should be continued beyond the next two years. While he agreed with Mr. de Maulde on the overall magnitude of allocations, he could not accept the idea of a conditional allocation of SDRs. About two thirds of the total could be allocated to the industrial countries; thus, the remaining SDR 5 billion each year would have little inflationary impact.

It was unrealistic to argue that an allocation would reduce the required adjustment effort in countries that had balance of payments difficulties, Mr. Tshishimbi continued. Most of those countries had been implementing severe adjustment programs with or without Fund financial assistance. The most common feature of their programs had been the curtailment of domestic expenditure, both public and private. Because the majority of those countries had high debt service ratios, the bulk of their resources, including Fund assistance, had been directed toward the repayment of their debts and of their arrears. In many cases, there had been little room to provide for a reasonable amount of imports to maintain, let alone increase, the productive capacity of the country. During the adjustment period, particularly if it was long, the countries had had to undertake structural reforms for which additional external resources were needed but had been provided in highly inadequate amounts. Thus, an SDR allocation along the lines that he had suggested could encourage members to continue with their adjustment efforts.

Most Directors agreed on the principle of an allocation, Mr. Tshishimbi observed, although views differed on the amount. To overcome the reluctance of some countries, ideas were being put forward to limit the use of the SDRs that would be allocated. Such proposals had the merit of trying to find a solution around which a compromise could be reached in the Executive Board. They seemed to have in common a link with the adjustment process--allocated SDRs should, in some sense, be stored and used gradually if adjustment was being carried out. However, his chair did not share the view that the SDR system should become a vehicle for providing conditional resources. Adjustment efforts should be pursued to correct internal and external imbalances, but linking SDR allocations to the adjustment process would only dilute their unconditional nature.

Conditionality in Fund programs had been reinforced in the past few years, Mr. Tshishimbi said, most recently with the broad reduction in access limits and the relative reduction in access to the special facilities. Fund conditionality remained a means of implementing the adjustment process efficiently and in a less painful fashion than if adjustment had been disorderly. Countries that had adopted the adjustment programs recommended by the Fund had done so in the hope that the hardships would be temporary. The Fund should encourage that attitude by continuing to mix conditional resources with unconditional resources; an allocation of SDRs was the only unconditional resource available to the Fund at present. In view of the reduction in access to the Fund's resources and, for many countries, to financial markets as well, he welcomed the staff's conclusion that there was a growing need to supplement global reserves not for a particular group of countries but for the whole international community. An allocation of SDRs would satisfy that need and would thereby reduce the importance of borrowed resources in the system, making the system less vulnerable to financial market disturbances. He also agreed with the view that an allocation of SDRs would enhance the position of the SDR relative to other reserve assets.

Mr. Leonard remarked that it was clear that developments since the previous meeting of the Interim Committee had not been such as to change the fundamental considerations pertinent to an allocation of SDRs. The most relevant consideration noted by the staff was the recovery in world trade associated with the pickup of economic activity and its implications for the growth in reserves. While the relationship between the growth of reserves and the growth of imports was imprecise and fluctuating, the rebuilding of reserves by many countries in 1983 and the first half of 1984 had been modest compared with 1974-81 and had not significantly raised the ratio of non-gold reserves to imports. Much of the increase in non-gold reserves, measured in SDRs, was the result of valuation factors rather than of additions to the stocks of various reserve assets.

He agreed with the staff that the projected expansion of global trade to 1986 suggested a need for an increase in reserves, Mr. Leonard continued. The demand could be met in a number of ways, possibly by increases in reserves in forms other than SDRs. However, the quality of reserves had to be borne in mind; it was not desirable that too much weight should be placed on borrowed reserves, even apart from the uncertainties attached to the borrowing capabilities of many developing countries. An important consideration was, therefore, the ratio of SDRs to total non-gold reserves. To further the objective of strengthening the role of the SDR in the international monetary system, it would be appropriate to satisfy some of the need for reserves through allocations in 1985 and 1986. The necessary adjustment by some countries benefiting from an allocation ought not to be endangered because those countries most likely to be net users of an allocation were already subject to Fund conditionality and surveillance. A further factor reducing the likelihood that countries would depart from their adjustment efforts was the reality that, where they were implementing Fund-supported programs, the availability of a substantial volume of new bank money hinged on the continuation of their efforts. Fears of inflation and increased inflationary expectations should be mitigated if the size of an allocation was relatively modest.

His chair wished to see a consensus emerge on the issue of an allocation, Mr. Leonard stated. In that spirit, and to promote the objective of enhancing the position of the SDR as a reserve asset, his authorities considered that annual allocations that would bring the cumulative SDR/non-gold reserve ratio above the 5.9 percent level reached in 1983 would be desirable. Allocations of about SDR 5 billion in 1985 and in 1986 would ensure such an outcome.

Ms. Bush noted that the staff compared reserve growth in the period 1974-81 with reserve growth in recent years. However, it was questionable whether the former period was appropriate as a basis for comparison, given the substantial growth in international lending in those years. Furthermore, recent data indicated that non-gold reserves had grown at an annual rate of 8 percent between the end of 1982 and the middle of 1984, a total increase of 12 percent. That situation compared favorably with the increase in reserves between 1974 and 1981, which had been substantial.

The staff suggested that inadequate international liquidity had made the creation of reserves the overriding objective of economic policy, Ms. Bush continued. However, while it was an important and prudent objective of economic policy in many countries, it had not always been an overriding objective. It was particularly prudent to augment owned reserves rather than borrowed reserves. Improved creditworthiness was also an important objective. On the other hand, the decline in access to credit reflected in part market judgments about economic policies; improved economic and financial policies and effective adjustment efforts led to improved access to credit; which would improve further in the near future as economic adjustment and recovery continued. The market reacted quickly to improved financial and economic conditions, as evidenced by the multiyear debt restructuring being negotiated by Mexico with its private creditors.

The world economic situation had continued to improve, Ms. Bush observed, and the maintenance of good economic management by all countries would enhance that recovery. On the basis of the preceding considerations, she did not believe that a convincing case had yet been made that there existed a global need for an SDR allocation as required under the Articles of Agreement. Indeed, recent evidence of improvements in the world economy and in reserves pointed increasingly in the opposite direction.

A number of Directors had asked her about recent discussions between her authorities and the U.S. Congress, Ms. Bush said. In an effort to respond to the spirit of the legislation that had enacted the quota increase for the United States, her authorities had had several meetings with congressional staff to keep them informed of the status of discussions on an SDR allocation and on her authorities' thinking about the issue; they believed that it was prudent to keep the Congress up to date on the matter. Finally, although they concluded that a convincing case had not yet been made, her authorities would continue to have an open mind and to consider the differing views and analyses on the question of an SDR allocation.

Mr. Alhaimus observed that in the course of extensive discussions of the subject of an SDR allocation in the fourth basic period considerable evidence, both quantitative and qualitative, in favor of an allocation had been presented by the staff in various papers. He reiterated his authorities' consistent support for an allocation.

The long-term global need for reserve supplementation was evidenced by, inter alia, the ongoing effort by many countries to build up their reserve positions after the recent abrupt shrinkage in international credit markets, Mr. Alhaimus continued. Moreover, as the staff indicated in SM/84/148, the term "global need" had never been intended to imply a uniform reserve need, nor had it been interpreted as such in earlier allocation discussions. An allocation of a reasonable size, as the staff clearly showed, would constitute such a small increase in global liquidity that adverse inflationary consequences were unlikely.

An allocation would not adversely affect the adjustment process, Mr. Alhaimus considered, because the ratio of conditional to unconditional resources would not be altered by much as a result of an allocation of reasonable size. In fact, by helping to alleviate the need for severe import compression in rebuilding reserve positions, an allocation could contribute to the revitalization of growth in many developing countries and hence to the strengthening of the adjustment process. Finally, if a consensus continued to exist on the importance of a cooperatively controlled international reserve asset for the promotion of international financial stability, there would be an urgent need to reverse the declining trend in the ratio of SDRs to non-gold reserves. Those and other arguments, which had been reiterated on many occasions in staff papers and during Executive Board discussions, underlined the case for a straightforward allocation of SDRs.

Mr. Juusela stated that his authorities were convinced that the economic environment had become increasingly favorable for an SDR allocation since the discussion by the Interim Committee in the spring of 1984. He reconfirmed his constituency's support for a moderate SDR allocation in the current basic period. He generally agreed with the staff's arguments in SM/84/191. The present economic setting and the projected growth of world trade indicated a clear need for increased international reserves. However, developing countries in particular, among which were many with Fund-supported programs, continued to face great difficulties in restoring the level of their international reserves through the still turbulent financial markets. It was an appropriate time, therefore, for an SDR allocation to supplement other sources of reserve creation. By helping countries with their reserve restoration efforts, an allocation could have a positive, albeit limited, stabilizing effect on the financial markets. He was not convinced that an SDR allocation of the order of magnitude that could be envisaged would pose a threat to improved price stability.

Even more than arguments based on cyclical factors, the long-term needs of the international monetary system and the wish to promote the SDR's role deserved emphasis, Mr. Juusela continued. To that end, further SDR allocations were of great importance, and SDR 4 billion should be regarded as the minimum annual allocation in the present basic period. However, if a longer-term agreement on further allocations could be reached, as his authorities would prefer, somewhat smaller annual allocations would be acceptable as a compromise. He was not yet in a position to comment on Mr. de Maulde's proposal, other than to note that it encompassed interesting issues and merited further study.

Mr. Morrell observed that his authorities were divided on the question of an allocation in the fourth basic period. Eight of the countries that had elected him supported the conclusions in SM/84/191 and favored significant SDR allocations in the remaining years of the fourth basic period. His Australian authorities, however, did not consider that a case had been made to support the resumption of allocations at present.

Those among his authorities who favored an allocation saw a need to meet the demand for reserves that would follow from the predicted expansion in world trade, Mr. Morrell continued. The staff's historical analysis in SM/84/148 made it clear that if such a need existed an allocation could be made, even if the need could or would be met in other ways. The fact that the adequacy of reserves could not be quantified precisely had not prevented an allocation of SDRs being made in the past. Indeed, the data indicated that present levels of non-gold reserves in relation to imports, while fluctuating, were broadly similar to those prevailing when allocation decisions had been taken in the past; in relation to trade imbalances, they were relatively low at present, particularly for non-oil developing countries. Previous allocation decisions had included consideration of indirect evidence. At present, such considerations included the damage that had been done in many countries by severe import compression, which might have been alleviated if the Fund had made SDR allocations earlier in the fourth basic period, and the unprecedented number of countries with Fund-supported programs. The legislative history demonstrated that the existence of Fund programs had been a factor influencing past allocations. Perhaps the significant factor distinguishing such periods from the present was the composition of the Fund's debt portfolio. His authorities who favored an allocation believed that the inflationary risk was minimal at present.

His Australian authorities remained unconvinced of the need for an allocation of SDRs, Mr. Morrell stated. They noted that the increase in global reserves in SDR terms had kept pace with the growth of world trade, notwithstanding the slowdown in international bank lending. The ratio of non-gold reserves to imports for all countries was currently as high as it had been at any time since 1978 and was only marginally lower than the average level in the period since 1970. In the view of his Australian authorities, countries were having difficulties in obtaining the required capital from international markets not because of a shortage of international liquidity but because of the uncreditworthiness of the borrowers. The solution lay, therefore, in more rigorous adjustment efforts rather than in further allocations of SDRs. They did not accept the validity of the arguments presented in the first paragraph of page 8 of SM/84/191, where the staff appeared to attempt to attribute many of the trends that concerned all Directors--increased protectionism, intensification of exchange restrictions, slow growth, and high unemployment--to reserve insufficiency. His Australian authorities also believed that if an SDR allocation was not to have an inflationary effect it would have to be so modest that it would be of no real help to the countries in need. The opposite also held true. With regard to Mr. de Maulde's suggestions, he did not believe that any of his authorities were ready to contemplate basic changes in the nature of the SDR. However, he would report the proposals to them.

Mr. Clark recalled that on previous occasions his chair had noted the difficulty of reaching a firm conclusion about long-term liquidity trends in a period when balance of payments positions remained seriously out of equilibrium and countries were undergoing short-term adjustment. Even when there were signs of a liquidity shortage, there were other channels in addition to an SDR allocation through which it might be remedied. In that connection, while he agreed with much of the analysis in SM/84/191, a more extensive discussion of the supply prospects for liquid assets would have been useful, particularly an examination of the present and prospective effects of the U.S. external deficit. He agreed fully with Mr. Grosche's point that, in responding to a perceived shortage of liquidity, it was necessary to look at factors affecting the demand for liquidity, especially the degree of uncertainty and volatility in the economic environment, and to consider how far policy measures in that area had a part to play. In sum, he was not convinced that a case had been made for an allocation according to the provisions of the Articles.

Mr. Fujino noted that the continuing expansion of world trade and activity expected in the next several years implied a growing need for international liquidity. The projections in the "World Economic Outlook General Survey" (EBS/84/177, 8/16/84) suggested that the pace of recovery was expected to be relatively fast. However, it would have been useful to discuss further the prospective demand for global liquidity, for example, through sensitivity analysis of the demand for liquidity and on various assumptions about the development of world trade. Due attention should also be paid to the current supply-side conditions affecting international liquidity. The United States, the major supplier of international reserves, had been and was expected to be running a large current account deficit. The declining trend in the availability of credit through international financial markets seemed to have come almost to an end, and it was possible that the amount of credit would increase as the prospects for economic recovery became brighter and progress was made in adjustment. Under the present complicated liquidity demand and supply conditions, great care had to be taken in examining proposals for a substantial expansion of global liquidity.

Another argument in favor of an allocation was that a large number of countries with Fund-supported programs were confronted with the problem of how to eliminate external arrears and rebuild reserves, Mr. Fujino continued. However, the real question was the extent to which the reserve shortage was associated with the long-term global need for reserve supplementation as opposed to the need to restore sustainable balance of payments positions through adjustment programs. It was not an easy question to answer, but in the global context it seemed that recent reserve accumulation had more or less kept pace with the recovery of international trade, as the ratio of reserves to imports had increased slightly over the period. The ratio of reserves to external debt for all non-oil developing countries had also increased somewhat during 1983 and was approaching the level that had prevailed in the first half of 1981. It should not be concluded from the fact that a number of developing countries were faced currently with liquidity shortages that there was a global shortage of liquidity.

SDR allocations should also be considered from a more general perspective, Mr. Fujino considered, including the role of the SDR in the international monetary system. Although the objective of making the SDR the principal reserve asset could not be the sole reason for the resumption of an allocation, each member assumed the obligation to collaborate with the Fund toward that objective. While his authorities believed that the present ratio of SDRs to non-gold reserves was not low by historical standards, they would pay attention to future movements in the ratio. His authorities would continue to watch closely the development of global liquidity and to judge its adequacy or inadequacy with an open mind on the basis of the Articles of Agreement.

Mr. Jaafar noted that his chair had argued for an allocation of SDRs in the fourth basic period on several previous occasions. The outcome had been disappointing despite the overwhelming evidence, in the views of many members, that present world economic circumstances amply demonstrated the global need to supplement existing reserves. In SM/84/191, the staff again addressed some of the objections raised on previous occasions against an allocation. The argument that an SDR allocation would carry the risk of global inflation and inflationary expectations was no longer an important issue in view of recent experience with inflation, especially in industrial countries. In any case, the staff did not see it as a threat in light of the amount of allocation envisaged in the next two years. He supported that view.

On the question whether an SDR allocation might weaken the resolve of "problem" countries to pursue adjustment policies, Mr. Jaafar said that he supported the opinion that such an impact would be limited, even if relaxation did occur--which he personally doubted--because of the modest amount of an SDR allocation that was envisaged. On the other hand, access to conditional resources had narrowed considerably over the past several years. An allocation in the remainder of the fourth basic period would help to ease somewhat the reserve stringency experienced by "problem" countries in their efforts to adjust. The question should be viewed not in terms of the availability of conditional rather than unconditional resources, but in terms of the availability of overall resources to support adjustment efforts. An SDR allocation would not impair, in general, the commitment of members to adjustment. As the staff pointed out, the availability of conditional resources for many members would hinge on the satisfactory conclusion of adjustment programs with the Fund. Thus, far from relaxing adjustment efforts, an allocation could facilitate such efforts.

He was satisfied with the staff's quantitative analysis, Mr. Jaafar stated. The data confirmed conclusions in favor of an allocation reached by the staff on previous occasions. As for the amount, he preferred an allocation of at least SDR 29-30 billion over the next two years, which would be in line with the forecast for imports and the trend growth in the real demand for non-gold reserves. Nevertheless, he could accept an allocation of SDR 20 billion over the next two years if that figure could help to forge a consensus in the Executive Board. He supported Mr. Polak's proposal that the allocation could be extended beyond the two remaining years of the fourth basic period.

While he agreed with many of the points raised by Mr. de Maulde in his interesting note, Mr. Jaafar remarked, he would prefer at present to have a straightforward allocation of SDRs in the traditional sense because it would guarantee uniformity of treatment and would be simpler to apply. In the interests of the objective of promoting the SDR as the principal reserve asset, he was not convinced of the case for reactivating the reconstitution obligation clause, but he was open to persuasion on that point if there was a definite move to allocate SDRs in excess of the SDR 30 billion that he had mentioned earlier.

Mr. Zhang said that the staff had again demonstrated objectively and adequately the necessity and appropriateness of a new allocation of SDRs at present. He fully supported its analysis and arguments. Two facts deserved particular emphasis. First, not all non-oil developing countries had equal access to international financial markets and, at the same time, the level of official development assistance in general had not risen to meet the increasing financing needs of those countries. Second, the Fund's ordinary resources were limited and made available under stringent lending conditions; moreover, the present access limits, which had already been reduced, would be subject to review. He urged the countries that had thus far opposed a new allocation to show the political will to reverse their positions so that a consensus for a new allocation could be reached at the forthcoming meeting of the Interim Committee. He regarded as reasonable the Group of Twenty-Four's suggestion that the amount of an annual allocation should be SDR 15 billion. Finally, he could not support a proposal that would make the allocation of SDRs conditional in any sense.

Mr. Sangare remarked that he regretted that it had not been possible thus far to reach agreement on SDR allocations in the fourth basic period, which had begun on January 1, 1982. As his chair had emphasized on previous occasions, the unfortunate situation was inconsistent with the intent of the Articles of Agreement that the SDR should be made the principal reserve asset in the international monetary system. All the technical studies on the subject by the Fund staff or by outside authorities had provided overwhelming evidence in support of new SDR allocations.

He hoped that a consensus would emerge from the present discussion that would enable the Chairman to report positively to the next meeting of the Interim Committee and would pave the way for an early resumption of SDR allocations.

All 17 countries represented by his chair strongly supported new, significant SDR allocations, Mr. Sangare continued. They believed that all the requirements for such allocations had been adequately met. The arguments in SM/84/191 and SM/84/148 supported that position. With regard to the requirement of the global need for reserve supplementation, his authorities continued to stress that it would be wrong to apply a narrow interpretation to that concept in the sense that that all countries had to experience reserve shortfalls simultaneously. In SM/84/191, the staff reaffirmed that "the demonstration of a global need does not require that every member country be shown to have a specific need." While the staff indicated that there had been some accumulation of reserves, the fact remained that "during the years 1981-83, the ratio of non-gold reserves to trade imbalances for all countries has remained virtually constant at a lower level than that generally observed in the 1970s." Furthermore, about 40 percent of the observed increase in the SDR value of foreign exchange reserves was accounted for by the valuation effects resulting from the appreciation of the U.S. dollar. Even so, the highly skewed distribution of existing reserves was common knowledge. Moreover, the continuing diminished access to international capital markets, which had sharply curtailed the availability of borrowed reserves; the inaccessibility of a large number of countries to such markets; the fact that many countries had to enter into special borrowing arrangements with the Fund in order to pay 25 percent of the increases in their quotas under the Eighth Review; and, last but not least, the unprecedented resort to import compression, trade restrictions, and the upsurge of protectionism were all clear manifestations of a liquidity shortage for the majority of members not matched by an "overabundance" of reserves by other members.

The volume of imports between the end of May 1984 and the end of 1986 was expected to increase by about 15 percent, Mr. Sangare observed, necessitating a growth of reserves in the same period of about SDR 57 billion. As a result, the staff stated, inter alia: "Thus an allocation of SDRs in each of the years 1985 and 1986 of SDR 29 billion would match the real growth of imports." Every one of his authorities had directed his attention to that statement and requested him to indicate that agreement along those lines would be acceptable to them. An allocation of such magnitude was also justified if the share of SDRs in total reserves was to be meaningful and to lead to the attainment of the goal of making the SDR the principal reserve asset of the international monetary system, a cardinal objective of the Articles of Agreement. In doing so, "the vulnerability of the system to financial market disturbances" would be reduced.

With regard to the concern about inflation, a number of points deserved emphasis, Mr. Sangare went on. First, there was considerable underutilization of capacity in many countries. Second, significant progress had already been made on the inflation front, and other forms of reserve creation were not likely to be less inflationary. Third, most of the new SDRs would accrue to those countries that were not in need and that could afford to sterilize their allocations. Consequently, he agreed with the staff that "an appropriate allocation of SDRs (which just satisfies the long-term global need for reserve supplementation) would not generate inflationary...pressures."

SDR allocations would play a complementary role to the adjustment efforts of members, Mr. Sangare said. Countries with adjustment programs supported by the Fund were most unlikely to relax their adjustment efforts and become spendthrifts. After all, their share of an allocation would be very small; only about one third of an allocation would go to all the countries currently facing balance of payments deficits. Furthermore, a much larger volume of capital inflows, both official and private, and debt reschedulings were now heavily dependent on sustained adjustment efforts. As the staff had pointed out, allocations could offer "some very modest relief from the strain of adjustment, by permitting some accumulation of reserves outside of the adjustment process itself, [and] would be regarded by some countries as an encouragement to press on with their efforts."

The interesting proposal made by Mr. de Maulde had a number of similarities to that put forward previously by Mr. de Groote, Mr. Sangare commented. He welcomed the genuine interest of their authorities in trying to find a positive solution to the SDR problem. However, some aspects of the proposal created difficulties that would inevitably have a negative effect on the principal characteristic of the SDR as an unconditional international reserve asset created by the collective will of all members of the Fund. That important aspect should not be lost sight of. As with the kind of conditional SDR suggested by Mr. de Groote, an element of conditionality remained very much a part of Mr. de Maulde's proposal. The idea of having two types of SDRs--conditional and unconditional--was far from satisfactory and was not acceptable to his authorities. As his chair had pointed out in 1983, international financing had become too conditional and there was no need to add further elements of conditionality.

There might also be problems with the financing of Fund programs, Mr. Sangare suggested. The implications of Mr. de Maulde's proposal for future quota increases were unclear. Use of conditional SDRs would not lead to increased access to Fund resources and would be of doubtful benefit to most members. The intent of the Articles should not be ignored. Moreover, it was not appropriate to raise the issue of the reconstitution obligation at present, a matter that his authorities regarded as already settled. If it was to be raised at all, it should not be in the context of SDR allocations.

In sum, Mr. Sangare concluded, his authorities maintained their well-known position in favor of an early resumption of SDR allocations. Such action was necessary to reduce the present undue reliance on one or two reserve currencies and on the vagaries of private markets for meeting the global need for reserve supplementation, a situation that made the system not only inherently unstable but also inequitable. An agreement on allocations would send an appropriate signal to the international financial community that the Fund was on course in making the SDR the principal reserve asset of the system. The evidence in favor of an allocation was overwhelming; he hoped that all Directors could agree to take a positive step forward in achieving the laudable objective set for the SDR by the entire membership of the Fund.

Mr. Weitz recalled that the question of an allocation of SDRs in the fourth basic period had been discussed on numerous occasions in recent years by the Executive Board without a decision in favor. The staff had provided a number of studies that had made the case for such an allocation abundantly clear. On the present occasion, additional evidence had been made available, reinforcing the technical arguments for supplementing existing liquidity through a fresh allocation of SDRs.

His chair continued to favor an allocation of SDRs for the remainder of the fourth basic period, beginning in 1985, Mr. Weitz continued. Such an allocation should be adequate, not merely symbolic. In that context, he supported an allocation of SDR 30 billion for the remainder of the period, and he believed that consideration should be given to deciding on an allocation for the years beyond 1986.

The Articles of Agreement and discussions in the Executive Board set out the relevant criteria for establishing the existence of a long-term global need for reserve supplementation, Mr. Weitz remarked. The staff clearly stated in SM/84/191 that those criteria had been met. An addition to the supply of liquidity to all members would improve present world economic conditions and would respond to the underlying trends in the international trade and financing systems, while being consistent with the purposes of the Fund. An adequate supply of reserves was of paramount importance for a sustained revival of world trade. The staff concluded that the apparent recent buildup of reserves in many countries was the result of the appreciation of the U.S. dollar and of the demanding efforts of countries that perceived their present levels of reserves as inadequate. However, the increase in reserves had not altered materially the ratio of non-gold reserves to imports and to trade imbalances. Furthermore, a comparison of the level of reserves to external debt owed to banks showed that some groups of countries, such as those in the Western Hemisphere, had suffered a considerable deterioration. Limited availability of credit from private financial markets and the debt problems of many developing countries were important considerations that needed to be taken into account when dealing with international liquidity. It was in the interest of all members to overcome the difficulties created by the sharp curtailment in liquidity stemming from those factors. There was no need to repeat the other factors mentioned by the staff as symptoms of present reserve inadequacy, such as a growing tendency toward protectionism.

Far from discouraging the present adjustment efforts being made by many members, Mr. Weitz went on, an allocation of SDRs would contribute enormously to the consolidation of world economic recovery, would constitute a recognition of the financial difficulties being faced by developing nations, and would reinforce the need to eliminate trade barriers. Finally, developments in the debt problem since 1981-82 suggested that a larger share of borrowed reserves in total non-gold reserves constituted a threat to the stability of the international monetary system. By enhancing the role of the SDR in the system through an allocation the risks would be reduced.

Mr. Salehkhou observed that the present discussion followed a number of earlier debates on the pros and cons of SDR allocation and that it was difficult to add to the points lucidly and forcefully presented by the staff. The main issue now was to reach a political consensus on the vast array of technical arguments that pointed overwhelmingly to the need for a sizable SDR allocation. He reiterated his general support for a substantial allocation.

In defining the concept of long-term global need, Mr. Salehkhou continued, care should be taken not to ignore its changing nature over time. Although an assessment of the potential need for reserve supplementation would inevitably involve elements of subjectivity that would change over time, some conceptual reinterpretation would also have to be permitted in view of the evolution of the system in the past 15 years. Judgments as to the ease or stringency of the long-term global reserve position necessitated alterations in the way in which the Fund assessed reserve adequacy. After 1973, floating exchange rates had in one sense lessened the need to hold as many reserves as previously required to defend fixed exchange rates. On the other hand, the need had increased in view of the reality of active intervention in exchange markets. Similarly, in defining the term "global," the key element was not so much a distinction between individual needs or the needs of groups of countries--compared with the total combined needs of all countries--as the effect of the requirements of each country or group of countries on the international financial system.

Given that the term "global need" was so imprecise, Mr. Salehkhou commented, greater use should be made of other qualitative criteria that took into consideration measures employed to finance prospective payments imbalances or to redistribute existing reserves. The rising trend of protectionism and other trade restrictions pointed to the inadequacy of the existing capital market mechanism to channel appropriate resources to the areas most in need of them. In other words, the problem was not so much the insufficiency of total available resources as the rigidity with which such resources could be channeled to needy members. Furthermore, as was evident from the staff's analysis, the distribution of reserves among members had become a relevant issue during the second basic period--1973-78. The point had been acknowledged by the Managing Director in 1973; unfortunately, a broad consensus had been lacking. However, the issue had once again become highly relevant. Obviously, some countries had ample reserves and did not require additional liquidity, but those countries that did require such liquidity far outnumbered the former--to the extent that meeting their credit requirements had become an urgent issue in any discussion of the reform of the international financial system.

An argument that had been emphasized to justify SDR allocations during the third basic period--that the consequences of such an allocation would improve the composition of the increases in reserves--also held true at present, Mr. Salehkhou considered. The proportion of SDRs in total reserves had decreased significantly, whereas it should have increased if the role of the SDR as the principal reserve asset was to be enhanced. In the report of the Executive Board to the Interim Committee in September 1978, it had been argued that a basis for allocation existed despite the fact that there was not a long-term global need to supplement existing reserve assets. Three reasons had been cited. First, members had embarked on an increase in their reserves in view of the impending expansion of world trade and transactions. Second, the existence of a global need did not require that there should be an existing shortage of reserves. Third, a decision to allocate SDRs to meet a global need did not have to be predicated on a finding that there was no other way to meet that need. Present conditions were similar with respect to the first two points, while the third point was even more compelling in the current situation. In 1977 and 1978, access to the international capital markets or to other credit sources had been easier than at present.

Financial developments during the 1980s had certainly strengthened the necessity of reaching a speedy consensus on an SDR allocation, Mr. Salehkhou suggested. Aside from the debt problems of some large borrowers, the developing countries were acutely in need of unconditional liquidity in view of the stringent capital market conditions that had resulted in a lack of access even to commercial credit. Their needs for such financial resources would profoundly affect the smooth functioning of the international monetary system. The argument that private credit flows to developing countries might compensate them for the shortage of official unconditional credit was not supported by the facts. Private flows to developing countries had steadily fallen in absolute terms; the decline was much more pronounced in real terms.

More generally, Mr. Salehkhou said, a conspicuous feature of capital market developments had been a decline in net new international credit through commercial banks and bond markets. In the case of non-oil developing countries, the slowdown reflected a skewed pattern marked by a highly selective concentration of lending to a few borrowers, mainly in Asia, and to large borrowers in conjunction with Fund-supported adjustment programs. The current projections in the "World Economic Outlook--General Survey" (EBS/84/177, 8/16/84) for the remaining years of the fourth basic period pointed to an increased debt service ratio of developing countries in almost all geographical regions. The increase in outstanding external debt during the past three years of no SDR allocations had proceeded at a rate that far exceeded the rise in their total reserves. Finally, he supported the position of the Group of Twenty-Four in favor of an annual allocation of at least SDR 15 billion, without conditions, in the remaining years of the fourth basic period and in favor of the establishment of a link between SDR allocations and development finance.

The Chairman made the following summing up:

A large majority of Directors expressed support for the staff paper (SM/84/191, 8/3/84), with a number of those speakers stressing that the considerations contained in that document had strengthened their views. The basic consideration underlined by those Directors was that in their judgment the fundamental condition for an SDR allocation in conformity with the Articles of Agreement has been met: there is, in their view, a clear long-term global need for reserve supplementation in the remainder of the fourth basic period. If the recovery of world trade takes place along the lines projected in the World Economic Outlook, a substantial increase in the demand for reserves will have to be satisfied. This macroeconomic evidence is enhanced by a number of supplementary considerations. A large number of countries, many of which are undertaking severe adjustment efforts, are facing clearly inadequate levels of reserves. The majority of those countries have limited or no access to financial markets, and the absence of an SDR allocation may force them to compress imports further.

It is, therefore, important, in the minds of those Directors, to understand the advantages of an SDR allocation for the international economic and financial system. A moderate allocation, some of those Directors observed, would not rekindle inflation or endanger adjustment, while it would contribute to meeting the global need for reserves. The existence of other possible means of reserve creation should not, in their view, detract from an allocation of SDRs. Indeed, SDR creation has qualitative advantages over borrowed reserves that should be taken into account.

As far as the amounts of allocations are concerned, the views of those Directors concentrated on a range from SDR 4-5 billion a year, which was considered "modest" or "moderate," to substantially higher amounts, SDR 10 billion or SDR 15 billion a year, in the course of the coming two years. I have also noted today a clear tendency among those Directors toward a lengthening of the period in which allocations might be made beyond the two remaining years of the current basic period; in this context, Directors underlined the fundamental long-term considerations set forth in the Articles of Agreement.

Other Directors stressed that, in their view, the case had not been made for an allocation of SDRs. They felt that the staff's arguments were open to a number of doubts or objections. First, the quantitative yardstick utilized by the staff, namely, the average ratio of reserves to imports, was not adequate in view of the period referred to in the staff paper. The period 1970-83 was one of high inflation and heavy bank lending that resulted in reserve creation, two characteristics that should not be regarded as normal, nor should their repetition be encouraged. If other years had been chosen, the judgment on the global reserve need might have been considerably different from that expressed by the staff. Second, the staff had not, in the view of those Directors, addressed adequately the supply-side aspects of the question of global need; in particular, the staff paper had not contained a quantitative analysis of the impact of the U.S. external deficit on the supply of liquidity. Third, those Directors emphasized that the existence of individual reserve inadequacies in a number of countries--which they fully recognized--did not justify the activation of a mechanism of reserve creation intended to meet the needs of the international system. The issue was not to engineer a global increase in liquidity but to address the problems of the countries that were faced with reserve inadequacies through adjustment in economic policies and the provision of conditional financing. Nonetheless, those Directors indicated that, although they had not been convinced by the staff's arguments, they kept an open mind on the matter.

A brief discussion was also devoted to the suggestions put forward by Mr. de Maulde and Mr. de Groote. While there did not appear to be strong support for the notion of "conditional SDRs" and for the reactivation of the reconstitution provision, nor for the specific techniques envisaged in those suggestions, a number of Directors expressed the wish to study further the ideas put forward by the Belgian and the French chairs and to come back to them later.

The voting positions have not changed from those noted in my previous summing up of the discussion of an SDR allocation (EBM/84/15, 1/25/84), and I will report this to the Interim Committee. In view of the work already undertaken by the staff and the Executive Board, the inevitable limitations of a quantitative demonstration of the global need for reserve supplementation, and the necesssity of reaching a consensus on the matter, the hope was expressed by a number of Directors that the political dimension of the problem would also be taken into account by the ministers in their next meeting.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/130 (8/31/84) and EBM/84/131 (8/31/84).

3. YUGOSLAVIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Yugoslavia has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Yugoslavia (EBS/84/65, Sup. 1 (4/19/84)) and paragraph 24 of the letter dated March 20, 1984 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia attached thereto.

2. The letter dated July 31, 1984 from the Deputy Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia shall be attached to the stand-by arrangement for Yugoslavia, and the letter dated March 20, 1984, attached to the stand-by arrangement, shall be read as supplemented and modified by the letter of July 31, 1984.

3. The Fund finds that, in light of the letter dated July 31, 1984, no additional understandings are necessary concerning the nonobservance of the performance criterion relating to the intention regarding public sector revenue referred to in paragraph 4.b(4) of the stand-by arrangement, and that Yugoslavia may proceed to make purchases under the stand-by arrangement. (EBS/84/185, 8/28/84)

Decision No. 7793-(84/131), adopted
August 31, 1984

APPROVED: June 24, 1985

LEO VAN HOUTVEN
Secretary

Note by Mr. de Maulde on Allocation of SDRs

Over the past two years, the French Government has supported and advocated the resumption of SDR allocations. The view that it held and is still holding is that such an allocation is--in present world economic circumstances--amply justified by the global need to supplement existing reserves. However, it is clear that, although a vast majority of member countries share this view, there are still important member countries that are not yet fully convinced that there is a case for an allocation.

In order to help the emergence of a consensus, this note offers a few comments and suggestions on possible ways to meet the concerns of all Fund members.

Clearly, the easiest option would still be a straightforward allocation of a modest amount (SDR 20 billion, with SDR 10 billion being allocated at the beginning of 1985 and a further SDR 10 billion at the beginning of 1986). However, it would have a very marginal effect on the reserves of heavily indebted countries. As an example, and assuming that the amounts allocated are not used for other purposes, the non-oil developing countries of the Western Hemisphere would receive SDR 1.46 billion. Such an amount would represent only 5.8 percent of the reduction in the non-gold reserves of these countries between the end of 1981 and the end of 1983. Taking gold into account, this percentage would be even lower.

In light of this, it would seem appropriate either to ensure that a larger share of allocations goes to indebted countries or to agree on a larger allocation. These two options could also be combined to some extent.

Various possibilities offered by the Articles of Agreement might be explored to enlarge the share of indebted countries in an SDR allocation. First, SDRs could be allocated on the basis of quotas prevailing at a date other than the date of decision. Such a basis could be, for instance, quotas prevailing before the last review. However, the improvement would then be negligible.

Second, the Belgian solution, or any similar one, is compatible with the Articles of Agreement, and basically attractive inasmuch as it could be focused--through the Fund--on priority needs, and allow control over allocated SDRs. However, it may run into practical difficulties in the short term, inasmuch as it would entail a new financing operation for the Fund and, therefore, require complex parliamentary agreements in some countries.

Third, a more fruitful possibility would draw on Article XIX, Section 2(c), which permits members to lend SDRs to other members. The scheme would only require a 70 percent majority to be set up, and could run along the following lines:

- industrial countries, and possibly some oil-producing countries, would commit themselves to lend SDRs, up to a given proportion of their new allocation, to developing countries;

- the interest rate would be that of the SDR;

- the drawings by developing countries would be linked to an appraisal, by the Executive Board, of the countries' need for reserves, their economic policies, and the prospect that the SDRs being lent would effectively strengthen their reserves;

- to avoid complex discussions, the drawings on participating industrial countries would be uniform in relation to their share in the overall allocation;

- for the sake of simplicity also, the reimbursement period for each drawing should be uniform. Given the purpose of the scheme--the consolidation of reserves--the reimbursement should be over the medium term and provide for a grace period.

Such a scheme would be fairly well balanced: developing countries would have to accept conditional SDRs, but this would apply only to those lent back by industrial countries. It would also probably avoid the need for parliamentary approval since it would involve lending to countries, which is already allowed by the Articles of Agreement.

In practice, the commitment could involve 50 percent of the SDRs allocated to participating countries. Assuming the participation of all industrial countries in the scheme, and an overall allocation of SDR 20 billion, this would increase by a maximum of SDR 6.28 billion the amount that could be made available to developing countries. As an illustration, assuming all non-oil developing countries meet the eligibility requirements and are the only countries to benefit from the lending of SDRs, the amount of SDRs made available to them would increase by 120 percent.

Such schemes may appear somewhat complex. Another alternative could, therefore, be a larger allocation, on the order of SDR 30 billion (SDR 20 billion in 1985 and SDR 10 billion in 1986).

In that case, it would be necessary to ensure that such a large allocation should be used to build up reserves rather than to increase imports and consumption. The need to prevent overly large drawings on designated currencies should also be borne in mind.

Such potential problems could be dealt with through a reactivation of the "reconstitution obligation," which has the great advantage of being a simple and technically well-known device. If SDR 30 billion were allocated, as much as 30 percent to 50 percent of the allocation might then be initially frozen through the reconstitution obligation. This would help to meet the concerns expressed by some about the monetary risks of a large allocation.